CROWDFUNDING 6.0: DOES THE SEC'S FINTECH LAW FAILURE REVEAL THE AGENCY'S TRUE MISSION TO PROTECT—SOLELY ACCREDITED— INVESTORS?

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This Article builds on our prior research employing case studies—either singly or globally—to serve as the analytic to newly trending matters in law and entrepreneurship. Specifically, this Article serves as the third installment of our trilogy in FinTech law, analyzing potential consequences of the Equity Crowdfunding portion of the JOBS Act, including the Securities and Exchange Commission's (SEC's) proposed regulations

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regarding equity crowdfunding for non-accredited investors.

This Article identifies that the current statutory and regulatory regime governing FinTech crowdfunding platforms is inequitable to the vast majority of the U.S. population. The Article then employs two case studies—one real and one hypothetical—to illustrate the SEC's deliberate indifference to, or astounding technological incompetence regarding, applying legal regimes to emerging technology and economic growth. These case studies evidence pain points faced by both potential investors and investees, in both the equity and debt portion of an enterprise's capital structure. Our thesis concludes that either the SEC is woefully classist in favor of the proverbial "Top 1%," or the agency is sadly incompetent in understanding the needs of entrepreneurs, people with small amounts of investment capital, and congressional mandates imposed on the SEC. The Article proposes interpretive, administrative, and congressional alternatives that we believe better comport with the intent of the JOBS Act. Despite President Obama's August 2014 pronouncement that the business community complains about regulation, this Article turns the President's logic on its head and demonstrates that the business community and the U.S. economy have suffered because of the lack of congressionally mandated regulation by the SEC.

"They [members of the business community] always complain about regulation. That's their job. Let's look at the track record. Let's look at the facts."[1]

—President Barack Obama, August 2014.

I. INTRODUCTION

In an era known for non-collaboration between Congress and the President,[2] one area where the executive and legislative branch successfully worked to agree on, pass, and transform a bill into law was 2012's Jumpstart Our Business Startups (JOBS) Act.[3] The JOBS Act's legislative history suggested that the law's creation occurred in hopes of spurring economic growth and job creation in the United States.[4] And the JOBS Act

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[1] *Barack Obama Talks to The Economist: An Interview With the President*, ECONOMIST (Aug. 2, 2014, 4:12), http://www.economist.com/blogs/democracyinamerica/2014/08/barack-obama-talks-economist.

[2] Derek Willis, *A Do-nothing Congress? Well, Pretty Close*, N.Y. TIMES, May 29, 2014, at A3, *available at* http://www.nytimes.com/2014/05/28/upshot/a-do-nothing-congress-well-pretty-close.html?_r=0.

[3] Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[4] *See, e.g.*, Pat Toomey, Op-Ed., *Let's Create Jobs Now*, POLITICO (Mar. 12, 2012, 10:26 AM), http://www.politico.com/news/stories/0312/73884.html (opining that

itself stated that the relevant federal agency for proposing and promulgating the applicable administrative rules and regulations would be the SEC.

The SEC has promulgated some rules and regulations regarding portions of the JOBS Act.[5] However, the SEC has released only delayed, vague, lengthy, and inquiry-laden proposed rules[6] regarding JOBS Act Title III's equity crowdfunding[7] provisions. This Article asserts that the SEC's delay in adopting equity crowdfunding rules (A) runs contra to the congressional intent of the JOBS Act (job creation and economic expansion), (B) serves as a boon for the so-called "Top 10%" of the U.S. economy, and (C) harms the so-called "bottom 90%."[8] Simply put, while the SEC continues to delay implementing any of its hundreds of pages of proposed equity crowdfunding rules, the U.S. economy continues to suffer.[9]

This Article presents two unique and timely overlays demonstrating why the SEC's refusal to move forward regarding equity crowdfunding rules represents a pain point. This problem underpins the Article's policy prescription of broadly permissive equity crowdfunding in the name of fairness for all investors, not just the elite. Specifically, Part I describes many of the various types of crowdfunding that exist. Part II then presents a case study from FinTech Law[10] that began organically in 2012 and

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the JOBS Act "represents a truly bipartisan plan for encouraging job creation and restoring a healthy economy").

[5] Crowdfunding, Securities Act Release No. 33-9470, 78 Fed. Reg. 66428 (proposed Oct. 13, 2013) [hereinafter Proposed Rule: Crowdfunding], *available at* http://www.sec.gov/rules/proposed/2013/33-9470.pdf.

[6] *Id.*

[7] The term "equity crowdfunding" refers to the crowdfunding of anything that one would consider an investment contract and, thus, a security under relevant laws. Thus, equity crowdfunding includes not just equity but also debt instruments and other investment contracts as more fully described *infra* Part III. Some crowdfunding websites prefer to refer to a crowd as a circle, while others have shied away from the crowd altogether and have simply kept the verb. *See, e.g.*, CIRCLEUP, https://circleup.com/ (last visited Oct. 12, 2014); DREAMFUND, http://dreamfund.org/ (last visited Oct. 12, 2014) (referring to funding circles and circle funding); TILT, tilt.com (last visited Oct. 12, 2014) (changing its name in August 2014 after several years of being known as "Crowdtilt").

[8] *See, e.g.*, Scott Winship, *Whither the Bottom 90 Percent, Thomas Piketty?*, FORBES (Apr. 17, 2014, 11:53 PM), http://www.forbes.com/sites/scottwinship/2014/04/17/whither-the-bottom-90-percent-thomas-piketty/.

[9] *See generally National Income and Product Accounts Gross Domestic Product, Third Quarter 2014 (Advance Estimate)*, U.S. DEP'T COM., http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm (last updated Oct. 30, 2014).

[10] The term "FinTechLaw" represents financial technology law or the mixture of law, finance, and technology. *See, e.g.*, FINTECH LAW REPORT: E-BANKING, PAYMENTS AND COMMERCE IN THE MOBILE WORLD (Legal Works 2013-14).

exploded in 2014, leaving contributors of financial capital in the dust, concentrating the financial rewards among a few wealthy. This part argues that dispersion of equity risk and reward better serves economic development than continued concentration among a few. Part III transitions from potential crowdfunding contributors to potential crowdfunding recipients by discussing the problems faced by graduate students relative to student loan debts that are all but non-dischargeable in bankruptcy.[11] Part IV presents a unique proposition of a human capital structure and the human cost of capital. Finally, Part V synthesizes, relative to Title III of the JOBS Act, the mantra that the only two emotions that exist in investing are fear and greed. In particular, Part V illustrates that (A) on the greed side, the SEC's failure to provide equity crowdfunding rules has allowed only the so-called rich to get richer, while forcibly omitting approximately 90% of the investor public from the ability to equity crowdfund, and (B) on the fear side, the inability of equity crowdfunding investors to invest directly in human capital structures harms access to capital for graduate students, disincentivizing some potential graduate students from embarking on a chosen career in fear of being saddled with non-dischargeable student loan debt.

The Article concludes that whether one approaches equity crowdfunding from the greed or the fear side, the SEC has neither fulfilled its mission of protecting investors nor comported with—or understood—the law as it relates to equity crowdfunding. The Article proscribes that, in light of the SEC's recent spectacular failures to protect investors from schemes such as Enron, scams such as Bernie Madoff's, and structures like the securitized sub-prime collateralized debt obligations that contributed greatly to the Great Recession, the SEC should ensure a fair distribution of capital by simply allowing the equity crowdfunding market to operate by the plain language of Title III of the JOBS Act. The SEC should do so by doing nothing but studying the crowdfunding marketplace for two years. Then, based on two years of data of peoples' circles and crowds helping fund projects, passions, desires, and dreams, rather than based on sheer speculation regarding the future,[12] the SEC could provide, if needed, appropriate rules to regulate known concerns in the equity crowdfunding markets.

II. CROWDFUNDING GENERALLY

Crowdfunding is an informal Internet-based method of generating

[11] Douglas Whaley, *How to Get Rid of Your Student Loans*, DOUGLAS WHALEY BLOG (June 13, 2014, 1:13 PM), http://douglaswhaley.blogspot.com/2014/06/how-to-get-rid-of-your-student-loans.html.
[12] As the SEC itself mandates, "past performance does not guarantee future results...." 17 C.F.R. § 230.482(b)(3)(i) (2014).

capital from the public at large, or the "crowd."[13] Crowdfunding materialized as a means for early-stage entrepreneurs to overcome the obstacles in raising capital following the 2008 global financial crisis. Crowdfunding has since emerged from a state of relative obscurity and evolved into a robust method of capital formation.[14] Evidencing crowdfunding's materiality in capital formation—and need of an understandable legal and regulatory paradigm—is the crowdfunding industry's approximate 1000% growth over the past five years.[15] In 2013, U.S. crowdfunding campaigns effectively raised over $2.7 billion.[16] Such expeditious expansion indicates a marked increase in the flow of capital, which has allowed many would-be cash strapped entrepreneurs to proverbially "break the walls down"[17] that once constrained them from pursuing their dreams.

Naturally, the crowdfunding industry has seen a recent flood of online crowdfunding ("funding") platforms catering to a variety of niche markets, including higher education.[18] Notably, education-related funding platforms, such as Upstart[19] and CommonBond,[20] allow individuals to finance the cost of pursuing a higher education in exchange for a percentage share of their future income.[21]

A. *Models*

Crowdfunding is currently comprised of five different models: (1)

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[13] Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011).
[14] WORLD BANK, CROWDFUNDING'S POTENTIAL FOR THE DEVELOPING WORLD 119 (2013), *available at* http://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf.
[15] *See* Catherine Clifford, *Crowdfunding Seen Providing $65 Billion Boost to the Global Economy in 2014 (Infographic)*, ENTREPRENEUR (Jan. 16, 2014), http://www.entrepreneur.com/article/230912.
[16] Jesse Aaron, *Vital Small Business Statistics, Trends and Facts for 2014*, GET BUSY MEDIA (Feb. 13, 2014), http://www.getbusymedia.com/vital-small-business-statistics-trends-and-facts-for-2014/.
[17] ADAM MORENOFF & JAMES A. JOHNSTON, BREAK THE WALLS DOWN (Koch Records 1999).
[18] *See generally* Anton Root, Editorial, *Crowdfunding Industry Trends and Statistics [Infographic]*, CROWDSOURCING.ORG (May 2, 2013, 2:00 PM), http://www.crowdsourcing.org/editorial/crowdfunding-industry-trends-and-statistics-infographic/25662 (estimating 536 crowdfunding platforms worldwide in 2012).
[19] UPSTART, https://www.upstart.com (last visited Dec. 17, 2014).
[20] COMMONBOND, https://commonbond.co/?utm_source=trackedlink&utm_medium=referral&utm_campaign=gglcompcbhp (last visited Mar. 17, 2014).
[21] James Surowiecki, *The New Futurism*, NEW YORKER (Nov. 4, 2013), http://www.newyorker.com/magazine/2013/11/04/the-new-futurism.

reward-based; (2) donation-based; (3) debt-based; (4) equity-based; and (5) licensing or royalties-based. These crowdfunding models are the same in that each model utilizes an online platform accessible to all internet users. Crowdfunding can occur at two stages, either ex ante or ex post.[22] Ex-ante crowdfunding involves raising capital on the front end to achieve a mutually desired result not yet realized.[23] Ex-post crowdfunding involves raising capital on the back end, after the result has already been achieved.[24] However, the difference between each crowdfunding model lies in what an individual receives in return for a monetary contribution. Although this Article focuses primarily on debt-based and equity-based crowdfunding in the context of graduate education financing, this section illustrates the distinctions inherent among the several crowdfunding arrangements.

1. *Reward-based*

Under the reward-based crowdfunding model, individuals receive some kind of non-monetary reward in return for their financial contributions. The rewards received can take many forms, both tangible and intangible. Tangible rewards include touchable physical items, such as apparel, posters, sample products, and other goods. Intangible rewards include nonmaterial things, such as VIP event admissions or name recognition in the closing credits of a crowdfunded feature film. The monetary value of such rewards typically pale in comparison to the dollar amount contributed, whether the rewards are tangible or intangible. Kickstarter is the most popular online platform that utilizes the reward-based crowdfunding.

2. *Donation-based*

Under the donation-based crowdfunding model, individuals receive nothing in return for their monetary contributions. Individuals merely donate or gift money without any expectation of receiving anything in return. The donation-based crowdfunding model is generally utilized to draw financial support for not-for-profit causes on either a macro- or micro-level. Donors provide money on a macro-level by donating to a non-profit organization promoting a particular social cause. Donors contribute funds on a micro-level by donating to support a disadvantaged individual. GoFundMe is one web-based platform that employs the donation-based crowdfunding model.

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[22] *See, e.g.*, Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?*, 29 LOY. L.A. ENT. L. REV. 375, 375 (2009).
[23] *Id.*
[24] *Id.*

3. *Debt-based*

Under the debt-based crowdfunding model, or person-to-person ("P2P") lending model,[25] individual lenders provide interest-bearing loans to individual borrowers.[26] P2P borrowers typically obtain many loans in various small amounts from many individual lenders. The repayment terms of P2P loans range from as short as one year to as long as five years.[27] According to the SEC, P2P notes are both investment contracts and notes constituting securities. Consequently, P2P lending is currently subject to the federal securities laws and P2P platforms are considered issuers for purposes of SEC registration.

The crowdfunding environment has changed dramatically since the SEC addressed P2P lending, including Congressional enactment of the JOBS Act in 2012 and subsequent SEC issuance of proposed crowdfunding rules in late 2013.

4. *Equity-based*

Under the pure equity-based crowdfunding model, individual investors receive some sort of financial return in exchange for their monetary contributions. Currently, the SEC has merely proposed rules regarding equity-based crowdfunding. Thus, equity-based crowdfunding is not available to the general investing public as a viable investment vehicle, pending the SEC's finalized crowdfunding rules.

However, the SEC amended Rule 506(c) of Regulation D, which lifted a ban that existed for approximately eighty years prohibiting general solicitations in limited offerings. As a result, one may utilize equity-based crowdfunding to finance a particular venture, provided that capital is obtained only from "accredited investors."[28]

5. *Royalties and Licensing*

Under the royalty-based or licensing-based crowdfunding model, various organizations invite individuals to participate in competitions where the individuals create an original work of authorship such as a song, graphic

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[25] Andrew Verstein, *The Misregulation of Person-to-person Lending*, 45 U.C. DAVIS L. REV. 445 *passim* (2011).
[26] C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 20 (2012).
[27] *See, e.g.*, Verstein, *supra* note 25, at 452–53.
[28] *See* 17 C.F.R. § 230.501(a) (2014); *Accredited Investor*, SEC.GOV, http://www.sec.gov/answers/accred.htm (last visited Aug. 12, 2014)(defining "accredited investor" in granular detail).

art, or literary piece and submit the work online.[29] By submitting the original work of authorship, the individual typically waives some or all intellectual property rights in the work, or grants a license to the organization allowing the organization to use the work in interstate commerce.[30] In exchange for waiving such rights, or in exchange for a license to use the work, the organization agrees to compensate the individual either by one-time cash payment, promise to share in the royalties produced by the work, contracts to produce further works, or other tangible rewards.[31] However, the individual or crowd only receives such compensation upon selection or winning the competition.

A common form of royalties-based crowdfunding occurs when organizations create competitions for the crowd to write a song.[32] In the age of the meme, websites have started competitions for the crowd to either create original memes or to place comical captions on existing photographs.[33] In 2014, in an attempt to tap into the crowd and save its dying sitcom lineup, the broadcast television network NBC launched a contest inviting individuals to create television sitcoms and submit their ideas to an NBC website.[34] The ten finalists will be selected and given the opportunity to workshop their ideas with NBC producers and writers.[35] The ultimate winners of the contest will have their sitcoms produced as pilots and pitched to NBC executives for the chance to become regular series.[36] The winners of the contest will be paid in cash.[37]

6. *Parameters of Title III of the JOBS Act*

Congress gave Title III of the JOBS Act the short titles of "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act

[29] Cristina Dominguez Fraile, A Study on Copyright Challenges in the Crowdsourcing Era (Dec. 2013) (unpublished comment) (on file with Berklee College of Music), *available at* www.copyrait.com/archivo/43.doc.
[30] *See generally* Kappel, *supra* note 22.
[31] *See generally id.*
[32] *Id.* at 378; *see also* Fraile, *supra* note 29.
[33] *See, e.g.*, Dougy, *Caption This Photo! (5 Photos)*, THECHIVE, http://thechive.com/2014/08/09/caption-this-photo-5-photos-8/ (last visited Aug. 15, 2014).
[34] James Hibberd, *NBC Asks Viewers for Better Sitcom Ideas*, ENT. WEEKLY (Apr. 8, 2014, 7:00 PM), http://insidetv.ew.com/2014/04/08/nbc-sitcom-contest/; NBC PLAYGROUND, https://www.nbcplayground.com/#/home (last visited Aug. 15, 2014).
[35] Hibberd, *supra* note 34.
[36] *Id.*
[37] *Id.*

of 2012" or "CROWDFUND Act."[38] The JOBS Act amends the Securities Act of 1933 ("33 Act") by creating an exemption for crowdfunding.[39] A crowdfunding transaction is exempt from the 33 Act if the total aggregate amount of securities sold to investors during a twelve month period is not more than $1,000,000; the aggregate amount sold to an investor by an issuer under this exemption in the preceding twelve months does not exceed $2,000 or five per cent of the investors net worth if the investor's annual income or net worth is less than $100,000 and ten percent of the investor's annual income or net worth if the investors annual income or net worth exceeds $100,000; the transaction is conducted through broker or funding portal that complies with Section 4A; and the issuer complies with the requirements of Section 4A(b).[40] Additionally, equity obtained by the investor must be held for one year before being eligible to be sold or traded to a third party.[41]

The largest criticism of the JOBS Act is that the $1,000,000 yearly cap on equity crowdfunding is too low, of which the SEC is aware.[42] An entrepreneur may be able to develop their product or service for under $1M within a 12-month period, however, $1M is insufficient to launch and scale a full-fledged business. One entrepreneur went as far as deeming the $1,000,000 annual limitation "arbitrarily and unnecessarily low."[43] Although the amount of capital required to run a business varies depending on the business, the CEO of start-up Advanced Hydro Inc. suggested that the SEC raise the $1,000,000 annual limitation to $2,000,000 or $3,000,000 since a manufacturing company would have "significant capital investment needs in equipment and labor" to manufacture a product in America.[44] At least with respect to manufacturing companies, over $1,000,000 is necessary

[38] Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106, 126 Stat. 306, § 301 (2012), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

[39] *Id.* § 302.

[40] *Id.* § 302(a).

[41] *Id.*

[42] Crowdfunding, 78 Fed. Reg. 66,428, 66,431 (proposed Nov. 5, 2013) ("Several commenters indicated that the $1 million maximum aggregate amount is too low."); Kurtis Urien & David Groshoff, *An Essay Inquiry: Will the JOBS Act's Transformative Regulatory Regime for Equity Offerings Cost Investment Bankers' Jobs?*, 1 TEX. A&M L. REV. 559, 577 (2014); Deborah L. Jacobs, *The Trouble with Crowdfunding*, FORBES (Apr. 17, 2014, 2:59 PM), http://www.forbes.com/sites/deborahljacobs/2013/04/17/the-trouble-with-crowdfunding/.

[43] *See* David B Kopp, *Comment to Proposed Rule: Crowdfunding*, SEC (Oct. 29, 2013), http://www.sec.gov/comments/s7-09-13/s70913-28.htm.

[44] Dileep Agnihotri, *Comment to Proposed Rule: Crowdfunding*, SEC.GOV (Oct. 23, 2013), http://www.sec.gov/comments/s7-09-13/s70913-3.htm.

to build a production plant for the product sold and to maintain a capable team to develop, scale, and market the manufacturing business.[45]

Pursuant to the JOBS Act, Congress authorized the SEC to "update the amount not less frequently than every five years based on the Consumer Price Index."[46] Despite acknowledging both commenter criticism concerning the $1,000,000 annual limitation and Congressional authorization to adjust such limitation, the SEC has refused to consider increasing the cap in excess of $1,000,000.[47] Quite confusingly, however, the SEC asked for public comment on whether issuers should be allowed "to accept commitments in excess of the $1 million limitation so that if an investor withdraws his or her investment commitment prior to the closing of the offering, the issuer would still be able to raise $1 million?"[48] Regardless of whether the SEC should raise the cap (which it should), the SEC (extension of the executive branch) does not have the authority to create or change laws passed by Congress (legislative branch).[49]

The median amount of money required for seed or angel investing is somewhere between $5,000,000 and $10,000,000.[50] According to CrunchBase data from 2009 to 2014 with a sample size of 3700 startups, the median seed funds raised from angels was $1.2M, while the median

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[45] *Id.*

[46] Proposed Rule: Crowdfunding, *supra* note 5.

[47] *See id.* ("We do not believe that Congress intended for us to modify the maximum aggregate amount permitted to be sold under the exemption when promulgating rules to implement the statute. Therefore, we are not proposing to increase the limitation on the aggregate amount sold.").

[48] *Id.* at 66,457.

[49] *See* Urien & Groshoff, *supra* note 42.

[50] Matt Ehrlichman, *Weekend Read: 3 Questions to Ask Yourself Before Raising Money*, WALL ST. J. (Aug. 8, 2014, 4:30 PM), http://blogs.wsj.com/accelerators/2014/08/08/weekend-read-3-questions-you-need-to-ask-yourself-before-raising-money/; Tim Huntley, *Raising Money from Angel Investors*, ENTREPRENEURIAL LIFE (Oct. 30, 2013), http://anentrepreneuriallife.com/raising-money-from-angel-investors/; Mark Sullivan, *Beam Raises $5M for Smartphone-connected Toothbrush*, VENTUREBEAT NEWS (Aug. 8, 2014, 8:00 PM), http://venturebeat.com/2014/08/08/beam-raises-5m-for-its-smartphone-connected-toothbrush/; *Fund in Focus: LVP Launches Mobile Gaming Vehicle*, UNQUOTE.COM (Aug. 8, 2014), http://www.unquote.com/unquote/analysis/2359266/fund-in-focus-lvp-launches-mobile-gaming-vehicle; Dennis Ford & Barbara Nelsen, *The View Beyond Venture Capital*, 19 NATURE BIOTECHNOLOGY 15 (2001), *available at* http://www.angelday.ch/uploads/events/10/asset/A3Angels-BM-06.pdf; Jeffrey J. Stewart et al., *Putting a Price on Biotechnology*, 19 NATURE BIOTECHNOLOGY 813, (2001), *available at* http://www.angelday.ch/uploads/events/10/asset/A3Angels-BM-06.pdf.

amount of seed funding raised from VCs was $1.5M.[51] Further, the median Series A raised from angels was $5.3M and $6.0M.[52] These figures provide a quantitative starting point for the amount of capital that startups require to operate optimally. The median amount of funds raised during the seed stage and Series A stage both exceed the $1M cap that Congress and the SEC has placed on the amount of capital an entrepreneur can raise via crowdfunding.[53]

Additionally, there is a potential cost of compliance at each of the stages of equity crowdfunding.[54] The disclosure and reporting requirements under the SEC's current proposed crowdfunding rules are neither simple nor clear. Such requirements are accompanied with high costs of compliance. The SEC's proposed rules impose three types of disclosures: (i) statutory, (ii) regulatory, and (iii) financial.[55] The statutory disclosures are those required under the JOBS Act, which include disclosing:

> [1] the name, legal status, physical address and Web site address of the issuer; [2] the names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20 percent of the shares of the issuer; [3] a description of the business of the issuer and the anticipated business plan of the issuer; [4] a description of the financial condition of the issuer; [5] a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount; [6] the target offering amount, the deadline to reach the target offering amount and regular updates regarding the progress of the issuer in meeting the target offering amount; [7] the price to the public of the securities or the method for determining the price; and [8] a description of the ownership and capital structure of the issuer.[56]

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[51] CrunchBase Daily, http://static.crunchbase.com/daily/content_twitter.html (last visited Nov. 10, 2014); Tomasz Tunguz, *The Optimal Seed Round Construction To Maximize Series A Success*, TOM TUNGUZ, http://tomtunguz.com/signaling-risk-data/ (last modified June 6, 2014).

[52] CrunchBase Daily, *supra* note 51.

[53] *Id.*

[54] *See* Jacobs, *supra* note 42; *see also* Proposed Rule: Crowdfunding, *supra* note 5, at 66,521 (providing table of costs, including legal costs, that shows $122,960 plus costs of preparing disclosures and filing forms for a full $1M round).

[55] Proposed Rule: Crowdfunding, *supra* note 5, at 66,437–39.

[56] *Id.* at 66,438.

The regulatory disclosures are disclosures that the SEC seeks to require, in addition to those already mandated by statute. The SEC has proposed, on their own volition, to mandate the following disclosures:

> [1] the name, Commission file number and Central Registration Depository number ("CRD number") (as applicable) of the intermediary through which the offering is being conducted; [2] . . . the amount of compensation paid to the intermediary for conducting the offering, including the amount of any referral or other fees associated with the offering; [3] . . . certain legends to be included in the offering statement; [4] . . . the current number of employees of the issuer; [5] . . . the material factors that make an investment in the issuer speculative or risky; [6] . . . the material terms of any indebtedness of the issuer, including the amount, interest rate, maturity date and any other material terms; [7] exempt offerings conducted within the past three years; and [8] . . . certain related-party transactions.[57]

Furthermore, notwithstanding the disclosures required by statute and the SEC, entrepreneurs and startups must also provide investors with specific financial disclosures at three different thresholds. First, issuers offering $100,000 or less must:

> [F]ile with the Commission, provide to investors and the relevant intermediary and make available to potential investors income tax returns filed by the issuer for the most recently completed year (if any) and financial statements that are certified by the principal executive officer to be true and complete in all material respects. . .[58].

For issuers offering $100,000 or less, the SEC's estimated total cost of compliance is between $12,960 (for issuers offering $25,000) and $17,960 (for issuers offering $100,000),[59] or 52% and 18% of the total offering size, respectively.[60]

Second, issuers offering more than $100,000, but less than $500,000, are required to "file with the Commission, provide to investors and the relevant intermediary and make available to potential investors financial statements reviewed by a public accountant that is independent of

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[57] *Id.* at 66,442.
[58] *Id.* at 66,443.
[59] Letter from David Burton, Senior Fellow in Econ. Policy, The Heritage Found., to Elizabeth Murphy, Sec'y, Sec. and Exch. Comm'n (Feb. 3, 2014), *available at* http://www.sec.gov/comments/s7-09-13/s70913-192.pdf.
[60] *Id.*

the issuer."[61] For issuers offering more than $100,000, but less than $500,000, the SEC's estimated total cost of compliance is between $25,460 (for issuers offering $150,000) and $55,460 (for issuers offering $500,000),[62] or 17% and 11% of the offering size, respectively.[63]

Third, issuers "offering more than $500,000 (or such other amount as the Commission may establish) are required to file with the Commission, provide to investors and the relevant intermediary and make available to potential investors audited financial statements."[64] For issuers offering over $500,000, the SEC's estimated total cost of compliance is between $47,960 (for issuers offering $500,000) and $122,960 (for issuers offering $1,000,000),[65] or 9.5% and 12% of the offering size, respectively.[66]

Issuers seeking to offer $500,000 or less are comprised of those small businesses most likely to utilize equity crowdfunding. Paradoxically, however, issuers who ultimately utilize equity crowdfunding and raise $500,000 or less must pay higher pro-rata compliance costs than issuers who raise over $500,000. Making matters even more convoluted, the SEC has proposed *ongoing* reporting requirements for equity crowdfunding issuers.[67] "To implement the ongoing reporting requirement in Section 4A(b)(4), the proposed rules would require an issuer that sold securities in reliance on Section 4(a)(6) to file a report on EDGAR annually, no later than 120 days after the end of the most recent fiscal year covered by the report."[68]

> When filing the annual report with the [SEC], an issuer would check the box for "Form C-AR: Annual Report" on the cover of the Form C. The issuer would be required to disclose information similar to the information required in the offering statement, including disclosure about its financial condition that meets the financial statement requirements that were applicable to its offering statement.[69]

Several variations of Form C exist, which is required when the issuer is filing: (a) the initial disclosures required for an offering made in reliance on Section 4(a)(6); (b) an amendment to a previously-filed Form C for an offering; (c) a progress update required by Section 4A(b)(1)(H) and the related rules; (d) the annual report required by Section 4A(b)(4) and its

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[61] Proposed Rule: Crowdfunding, supra note 5, at 65.
[62] Burton, *supra* note 59.
[63] *Id.*
[64] Proposed Rule: Crowdfunding, *supra* note 5, at 65.
[65] Burton, *supra* note 59.
[66] *Id.*
[67] Proposed Rule: Crowdfunding, *supra* note 5, at 92.
[68] *Id.* at 94.
[69] *Id.* at 66,451.

related rules; and (e) a disclosure terminating reporting obligations pursuant to Section 4A(b)(4) and the related rules.[70] These ongoing reporting requirements continue until either:

> (1) [T]he issuer becomes a reporting company required to file reports under Exchange Act Sections 13(a) or 15(d); (2) [t]he issuer or another party purchases or repurchases all of the securities issued pursuant to Securities Act Section 4(a)(6), including any payment in full of debt securities or any complete redemption of redeemable securities; or (3) the issuer liquidates or dissolves its business in accordance with state law.[71]

An issuer must also post their annual reports on its website.[72]

These reporting requirements under the SEC's proposed equity crowdfunding rules appear much more demanding than required by other transaction exemptions under the 33 Act. For instance, Regulation D does not impose affirmative reporting requirements if the only purchasers are accredited investors.[73] Regulation D's prescribed disclosure requirements depend on the size of the offering and the nature of the issuer,[74] and, if an issuer is a non-reporting company, the prescribed disclosures are required only "to the extent material to an understanding of the issuer, its business, and the securities being offered."[75]

Such daunting disclosure and ongoing reporting requirements will require small startups to spend more time complying with the proposed regulatory framework instead of focusing on product development and business operations.[76] By fashioning complicated and demanding regulatory schemes, the SEC ultimately forces oft cash-strapped entrepreneurs "to devote a significant portion of the proceeds of a crowdfunding offering to the payment of legal, accounting and financial advisory fees,"[77] which causes a huge loss in productivity since identifying, understanding, and complying with such regulations requires a lot of resources that most starting entrepreneurs don't have to retain in-house counsel or a chief

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[70] *Id.* at 453.
[71] *Id.* at 96.
[72] *Id.* at 105.
[73] *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 300 (7th ed. 2013).
[74] *See id.* at 301.
[75] *Id.*
[76] Ubon Isang, *Comments on S7-09-13 Crowdfunding*, SEC.GOV (Oct. 24, 2013), http://www.sec.gov/comments/s7-09-13/s70913-8.htm.
[77] Catherine T. Dixon et al., *Comment to Proposed Rule: Crowdfunding*, SEC.GOV (May 18, 2014), http://www.sec.gov/comments/s7-09-13/s70913-319.pdf.

financial officer.[78] As one commenter suggested during the SEC's proposed equity crowdfunding rules' notice and comment period,

> If the Commission overregulates crowdfunding, it will frustrate the bi-partisan intention of Congress and the President and impede both the ability of small firms to raise the capital they need to create jobs, innovate and contribute to the prosperity of the country and the ability of small investors to invest in the firms with the most potential growth.[79]

B. *Synthesis*

Considering the statutory and proposed regulatory requirements, equity crowdfunding may appear less appealing and impractical when compared with Regulation D, a scenario that is almost nonsensical.

Despite the costs of raising capital and issuing securities to the public, the benefits of raising capital can quite successfully outweigh the costs. To illustrate this point and what could happen if the public or crowd is allowed to provide seed investment through crowdfunding, see the following case study regarding Oculus Rift.

III. OCULUS RIFT'S RIFT: A CASE STUDY OF REWARDS-BASED CROWDFUNDING GONE AMOK AMONG CAPITAL CONTRIBUTORS

"I would rather have bought a few shares of Oculus rather than my now-worthless $300 VR Headset."[80]

—Carlos Schulte

In the eighteen months between late 2012 and early 2014, Oculus VR, Inc., commonly known as Oculus Rift ("Oculus" or "Company"), went from essentially nothing to humbly creating a rewards-based crowdfunding

[78] John Dearie, *Entrepreneurship is the Key to Economic Growth and Job Creation*, ECON. POL'YS FOR THE 21ST CENTURY (May 29, 2014), http://www.economics21.org/commentary/entrepreneurship-key-economic-growth-and-job-creation.
[79] Burton, supra note 59.
[80] Adrianne Jeffries, *If You Back a Kickstarter Project That Sells for $2 Billion, Do You Deserve to Get Rich?*, VERGE (Mar. 28, 2014, 10:13 AM), http://www.theverge.com/2014/3/28/5557120/what-if-oculus-rift-kickstarter-backers-had-gotten-equity [hereinafter Jeffries, *Kickstarter*] (quoting Carlos Schulte, *Comment to Oculus Rift: Step into the Game*, KICKSTARTER (Mar. 25, 2014), https://www.kickstarter.com/projects/1523379957/oculus-rift-step-into-the-game/comments?cursor=6299270#comment-6299269).

campaign on Kickstarter for seed funding[81] to having Facebook acquire Oculus for two billion dollars. This Part uses the SEC's current equity crowdfunding rulemaking paralysis as an overlay to illustrate the legal and socioeconomic problems presented by the Oculus seed-round capital raise case study.

A. *A Brief History of Oculus Rift and Other Gaming Crowdfunding*

Oculus sought to operate in the virtual reality and gaming sector of the technology space.[82] The nexus of FinTech, gaming, and obtaining material crowdfunding amounts for southern California-based businesses was not unique to Oculus. For example, OUYA, an Android-based video gaming console enterprise,[83] ran a rewards-based Kickstarter campaign from July 10, 2012 through August 9, 2012. OUYA raised $2.59 million in a single day of crowdfunding and became the fastest crowdfunding project to raise one million dollars (eight hours and twenty-two minutes),[84] despite a stated funding goal of $950,000,[85] an amount that incidentally comports with the equity crowdfunding caps of Title III of the JOBS Act.[86] OUYA's crowdfunding campaign ultimately raised approximately $8.6 million from

[81] *See, e.g.*, THERESE H. MAYNARD & DANA M. WARREN, BUSINESS PLANNING: FINANCING THE START-UP BUSINESS AND VENTURE CAPITAL FINANCING 18 (2010) ("Seed capital is primarily available from the entrepreneur, 'friends and family,' an institutional angel investor and/or a prospective customer. *Seed capital financing is needed to . . . satisfy the validation requirements for a VC financing.*")(emphasis added).
[82] *Oculus Rift: Step into the Game*, KICKSTARTER, https://www.kickstarter.com/projects/1523379957/oculus-rift-step-into-the-game (last visited Aug. 4, 2014).
[83] Anton Root, *OUYA Breaks Records, Raises $2.5 Million in a Day on Kickstarter*, CROWDSOURCING.ORG (July 12, 2012, 4:27 PM), http://www.crowdsourcing.org/editorial/ouya-breaks-records-raises-25-million-in-a-day-on-kickstarter/16788.
[84] *Id.*
[85] *OUYA: A New Kind of Video Game Console*, KICKSTARTER, https://www.kickstarter.com/projects/ouya/ouya-a-new-kind-of-video-game-console/posts (last visited Aug. 8, 2014). Having said that, OUYA's campaign was not without controversy and scandal. *See, e.g.*, Russell Brandom, *Allegations Fly in Mysterious Ouya Crowdfunding Scandal*, VERGE (Aug. 29, 2013, 4:13 PM), http://www.theverge.com/2013/8/29/4672822/allegations-fly-in-mysterious-ouya-crowdfunding-scandal; Stephanie Tang, *Ouya Involved in Kickstarter Crowdfunding Scandal*, GAMESKINNY (Sept. 2, 2013), http://www.gameskinny.com/5zj0v/ouya-involved-in-kickstarter-crowdfunding-scandal. What the SEC could have done about such a scandal had OUYA sold equity is opaque.
[86] KICKSTARTER, https://www.kickstarter.com/projects/ouya/ouya-a-new-kind-of-video-game-console/posts (last visited Aug. 8, 2014).

nearly 63,500 funders[87] and remained the most-viewed project page in Kickstarter's history as of August 2014.[88]

OUYA's impressive fundraising did not, however, necessarily translate to corresponding successes for funders of the business, as OUYA since has pivoted from gaming hardware to software-based products.[89] And in that regard, Oculus represents a stark contrast to OUYA. Recalling that the JOBS Act became law on April 5, 2012,[90] fewer than four months later and only nine days following the completion of OUYA's material crowdfunding raise, Oculus began its rewards-based Kickstarter campaign on August 1, 2012.[91] It offered rewards like t-shirts, posters, hardware technology, and other giveaways at various funding levels.[92]

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[87] *Id.*

[88] Fred Benenson & David Gallagher, *Potato Salad: By the Numbers*, KICKSTARTER (Aug. 5, 2014), https://www.kickstarter.com/blog/potato-salad-by-the-numbers.

[89] Charles Luzar, *Not Enough Demand for Ouya Hardware Despite Their Huge Crowdfunding Campaign*, CROWDFUND INSIDER (Mar. 9, 2014, 12:16 PM), http://www.crowdfundinsider.com/2014/03/33404-enough-demand-ouya-hardware-despite-huge-crowdfunding-campaign/.

[90] Jumpstart Our Business Startups Act of 2012, Pub. L. No. 112-106, 126 Stat. 306 (2012), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

[91] *OUYA: A New Kind of Video Game Console*, *supra* note 85. *See supra* note 91 and accompanying text and chart on the next page displaying the crowdfunding reward levels offered by Oculus.

[92] *Id.*

Oculus' Crowdfunding Amount Levels for Distinct Rewards (in $)	Oculus' Offered Reward at Specified Funding Level	Number of "Investors"
10	"sincere thanks"	1009
15	"limited-edition poster for the Oculus Rift"	209
25	limited edition t-shirt for the Oculus Rift, only available via Kickstarter	434
35	OCULUS T-SHIRT + POSTER: A limited edition t-shirt and poster for the Oculus Rift, only available via Kickstarter	179
75	SIGNED OCULUS T-SHIRT + POSTER: The limited edition t-shirt and poster for the Oculus Rift, both signed by the entire Oculus team	106
184.4632588	N/A*	626
275	UNASSEMBLED RIFT PROTOTYPE KIT + DOOM 3 BFG: Try building the prototype yourself! You'll receive your own DIY kit for building the Rift from scratch	100
300	EARLY RIFT DEVELOPER KIT + DOOM 3 BFG, including includes a copy of Doom 3 BFG and full access to our Developer Center for our SDK, docs, samples, and engine integrations	5644
335	EARLY RIFT DEVELOPER KIT + DOOM 3 BFG + T-SHIRT + POSTER	859
500	SIGNED EARLY RIFT DEVELOPER KIT + DOOM 3 BFG + T-SHIRT + POSTER	66
575	2x EARLY RIFT DEVELOPER KIT + DOOM 3 BFG	216
850	3x EARLY RIFT DEVELOPER KIT + DOOM 3 BFG	40
1400	5x EARLY RIFT DEVELOPER KIT + DOOM 3 BFG	20
3000	STUDIO PACK - 10x EARLY RIFT DEVELOPER KITS + PREMIUM SUPPORT EVALUATION + DOOM 3 BFG	7
5000	VISIT OCULUS FOR THE DAY + ALL OF THE ABOVE	7

*The N/A line is an assumption based on averages that are not reported but must be included because the averages are based on the number of funders and total dollars raised.

Oculus' search for a quarter million dollars of crowdfunded seed financing lasted one month, until September 1, 2012.[93] Before its Kickstarter campaign, Oculus was a generally unknown gaming and tech entity outside

[93] *OUYA: A New Kind of Video Game Console*, *supra* note 85; Oculus *Rift: Step into the Game*, *supra* note 82.

of its base in Long Beach, California.[94] However, after a month of crowdfunding during which Oculus raised $2,437,429—nearly ten times its fundraising goal—Oculus began appearing in the media and on the radars of more traditional Series A- and Series B-round financiers.[95]

Approximately nine months later, on June 19, 2013, after Oculus had left the sublime style that stemmed straight from Long Beach,[96] Oculus had moved its headquarters south to the more conservative city of Irvine[97] in Orange County, California, and announced via press release that it obtained Series A financing from co-leaders Spark Capital and Matrix Partners (who had been early-stage investors in Twitter and SanDisk, respectively), along with Formation | 8 and Founders Fund.[98] As is typical with venture capitalists (VCs), Oculus' founders sacrificed material control rights to the VCs, allowing members of Spark Capital and Matrix Partners to join Oculus' board of directors.[99] This funding round—along with California's laws that prohibit enforcement of employee non-compete agreements except in the most limited circumstances[100]—quickly enabled (allowed?) Oculus to lure the services of renowned programmer John Carmack as its new Chief Technology Officer (CTO).[101]

Within weeks of Carmack's hiring as CTO, in mid-December 2013, Oculus secured an additional seventy-five million dollars of financing from Andreessen Horowitz, a VC firm created by Marc Andreessen, the founder

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[94] This Article's three authors make this assertion based on their respective locations in southern California, all within 30 miles of Long Beach during this time, and the lead author's position as a twice-published author on crowdfunding.

[95] *See, e.g.*, JC Fletcher, *'Oculus Rift' VR Headset Kickstarter Funded in 24 Hours*, JOYSTIQ, http://www.joystiq.com/2012/08/02/oculus-rift-vr-headset-kickstarter-funded-in-24-hours/ (last visited Aug. 8, 2014).

[96] SUBLIME, WHAT I GOT (Gasoline Alley Records, 1997).

[97] *About Oculus VR*, OCULUS VR, http://www.oculusvr.com/company/ (last visited Aug. 8, 2014); Jenna Wortham, *Creator of a Virtual Reality Sensation*, N.Y. TIMES, Mar. 27, 2014, at B1, *available at* http://www.nytimes.com/2014/03/27/technology/creator-of-a-virtual-reality-sensation.html.

[98] *See, e.g.*, Jessica Conditt, *Oculus Rift Secures $16 Million in First Round of Investor Funding*, JOYSTIQ, http://www.joystiq.com/2013/06/17/oculus-rift-secures-16-million-in-first-round-of-investor-fundi/; Ben Gilbert, *Oculus Snags $16 Million from Investors to Bring Virtual Reality to the Masses*, ENGADGET, http://www.engadget.com/2013/06/17/oculus-rift-16-million/.

[99] Gilbert, *supra* note 98.

[100] CAL. BUS. & PROF. CODE § 16600 (West 2014); CAL. LAB. CODE § 432.5 (West 2014).

[101] Danny Cowan, *John Carmack Departs ID Software*, JOYSTIQ, http://www.joystiq.com/2013/11/22/john-carmack-departs-id-software/; Mike Suszek, *Carmack Joins Oculus VR as Chief Technology Officer [Update]*, JOYSTIQ, http://www.joystiq.com/2013/08/07/carmack-joins-oculus-vr-as-chief-technology-officer/.

of Internet browser, Netscape.[102] Presumably to make this funding round as non-dilutive[103] as possible for the Series A investors, this Series B round included additional investment from Series A investors Spark, Matrix, and Formation | 8.[104] The Series B round thus provided significant financial capital to Oculus but also raised the Company's valuation materially.

Earlier this year, in mid-March 2014, only three months following the Andreessen Horowitz-led Series B round, Facebook acquired Oculus.[105] And Facebook paid $2 billion to acquire Oculus.[106] As a result, in approximately a year-and-a-half, Oculus went from having only option value to a value of $2 Billion, and many crowdfunders from Oculus' Kickstarter campaign were not pleased that they were unable to share in the riches. One crowdfunder wrote the quote that began this Part.[107] Another crowdfunder with an equity component to his username—@stockwitzjohn—tweeted, "I Helped Oculus Get Sold for $2 Billion and All I Got was This Lousy T-Shirt $FB #Kickstarter," which included a picture of him wearing the t-shirt he presumably received from Oculus as his funding reward.[108] Another Oculus crowdfunder, @joeljohnson, tweeted, "Can't stop thinking about how the Oculus+FB acq. [acquisition] makes me more and more frustrated with Kickstarter, as well."[109]

This chain of events raises many questions, a number of which are beyond this Article's scope. However, some relevant questions for this inquiry include whether @joeljohnson's frustration should be directed toward Kickstarter or instead to the SEC. Unless @joeljohnson were an accredited investor,[110] Kickstarter could not permit equity crowdfunding on

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[102] Dean Takahashi, *Oculus VR Raises $75M Round Led by Web Browser Inventor Marc Andreessen's VC Firm to Launch Virtual-reality Goggles*, VB GAMESBEAT (Dec. 12, 2013, 6:32 PM), http://venturebeat.com/2013/12/12/oculus-vr-raises-75m-from-andreessen-horowitz-to-create-consumer-version-of-its-virtual-reality-goggles/.

[103] For more on dilution as further private equity funding rounds occur, see George Triantis, *Financial Contract Design in the World of Venture Capital* (John M. Olin Program in Law and Economics Working Paper No. 115) (2001).

[104] Takahashi, *supra* note 102.

[105] Erin Griffith, *Facebook Buys Oculus VR, a Virtual Reality Gaming Company, for $2 Billion*, FORTUNE (Mar. 25, 2014, 10:08 PM), http://fortune.com/2014/03/25/facebook-buys-oculus-vr-a-virtual-reality-gaming-company-for-2-billion/.

[106] *Id.*

[107] *See* Schulte, *supra* note 80..

[108] @whatevermelloy, TWITTER (Mar. 26, 2014, 5:20 AM), https://twitter.com/stocktwitsjohn/status/448796591810691072/photo/1.

[109] @joeljohnson, TWITTER (Mar. 26, 2014, 4:10 AM), https://twitter.com/joeljohnson/statuses/448778902203564032.

[110] For the definition of accredited investor, see 17 C.F.R. § 230.501(a) (2014). *See Accredited Investor*, *supra* note 28, which further defines "accredited investor" as:

its platform without violating the law and facing the scrutiny of the SEC. The Commission is led for the first time in history by a former federal prosecutor, Mary Jo White, who has been known to make headline-grabbing attention with her over-the-top—and embarrassingly unsuccessful—enforcement behavior against noted celebrities, recently including billionaire entrepreneur and *Shark Tank* investor Mark Cuban and golfer Phil Mickelson.[111] Of course, the equity crowdfunding prohibition has not stopped certain leading crowdfunding websites from raising equity crowdfunding in violation of applicable laws and regulations and the SEC from missing more important items of note, such as high frequency trading, that permit otherwise-illegal frontrunning.[112]

B. *Analyzing the Actual Capital Flows to Oculus Rift*

Unlike Kickstarter, wefunder serves as a web platform for accredited investors to make equity investments.[113] Having said that,

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(1) a bank, insurance company, registered investment company, business development company, or small business investment company;
(2) an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;
(3) a charitable organization, corporation, or partnership with assets exceeding $5 million;
(4) a director, executive officer, or general partner of the company selling the securities;
(5) a business in which all the equity owners are accredited investors;
(6) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person;
(7) a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or
(8) a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

[111] Dina ElBoghdady, *Billionaire Mark Cuban Takes on the SEC*, WASH. POST (Nov. 20, 2013), http://www.washingtonpost.com/business/economy/billionaire-mark-cuban-takes-on-the-sec/2013/11/20/2b67134a-4a7c-11e3-be6b-d3d28122e6d4_story.html; Matthew Goldstein & Ben Protess, *Golfer's Role in Trading Said to be Overstated*, N.Y. TIMES, Jun. 12, 2014, at B1, *available at* http://dealbook.nytimes.com/2014/06/11/mickelson-said-not-to-have-traded-clorox-stock/?_php=true&_type=blogs&_r=0.

[112] *See generally* MICHAEL LEWIS, FLASH BOYS: A WALL STREET REVOLT (W.W. Norton & Co. 2014).

[113] *Our Guide to Startup Investing*, WEFUNDER, https://wefunder.com/faq (last visited Aug. 8, 2014).

Wefunder is actually the investor, not the individual accredited investor, which Wefunder claims helps keep a clean capitalization table for future VC investment.[114] Regardless, Wefunder claims to have helped pass the JOBS Act, and one of Wefund's founders was present at President Obama's ceremony signing the JOBS Act into law. As Wefunder claims on its website,

> [Wefunder] believe[s] that when all Americans can invest in innovation, the world will be a better place. And soon, our dream will become a reality. Thanks to the JOBS Act, everyone—not just the wealthy—will be able to invest as little as $100 in the startups they care about. Not only does this open up the pool of investors, and increase the amount of great ideas that get funded, but it allows startups to grow an army of passionate investors who truly want to see them succeed. Second[-]tier [VCs] will become obsolete as startups tap their lead users and customers for quick early investments . . . . The SEC won't implement Title III of the JOBS Act - allowing anyone to invest, regardless of income - until the summer of 2014 at the earliest. We can't wait for the day![115]

Wefunder co-founder, Nick Tommarello, stated that another reason his team launched Wefunder was the belief that "society would have been better served if thousands of early Facebook users had also provided the seed capital . . . and reaped the rewards."[116] This Article's authors agree with that premise (despite disagreeing with Wefunder's model of separating economic and control rights), which serves as the backdrop of the Article's strong policy proscription.

Given this agreement in principle, along with Wefunder's founders' experience at respected FinTech institutions, including MIT, Babson, and Y Combinator,[117] the analysis of one of Wefunder's founders, Greg Belote, relative to the valuation of Oculus' crowdfunders, were the investment equity-based, rather than rewards-based, has merit, even if we as authors quibble with some of the assumptions that are beyond the scope of this Article.[118] Put simply, Belote's valuation assumed a pre-crowdfunding

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[114] *Frequently Asked Questions: What Is a Wefunder?* WEFUNDER, https://wefunder.com/faq/common_questions#q37 (last visited Aug. 8, 2014).
[115] WEFUNDER, https://wefunder.com/wefunder (last visited Aug. 8, 2014).
[116] Nick Tommarello, *Why We Started Wefunder*, NICK TOMMARELLO BLOG (May 5, 2012), http://nick.tommarello.com/post/28803708233/why-we-started-wefunder.
[117] Disclosure: The spouse of one of this Article's authors is an employee, director, and equityholder in a Y-Combinator-funded, MIT-spinoff startup.
[118] For example, Belote assumes convertible debt, rather than convertible preferred equity and that the Company had pre-crowdfunding money equity value of $12 million versus our view of it having nominal or option

money equity valuation of $12 million and a $1,000 crowdfunding equity valuation, a 15% giveaway in each of the Series A and Series B rounds of $16 million and $75 million, respectively.[119] This scenario translates to pre-money valuations of $90 million and $425 million, respectively.[120]

Therefore, first, the equity value is $1,000 per crowdfunder. Second, Belote's back-of-the-envelope calculations assume a post-money valuation of $5,100 following the Series A financing round.[121] Third, following the Series B dilution and valuation increase, Belote assumes that the initial $1,000 crowdfunding contribution translates to a post-Series B money value of approximately $20,500.[122] Finally, the $2 billion acquisition by Facebook represents a value of $145,000, thereby representing a 145x return on the hypothetical equity crowdfunded investment in the eighteen months between August 2012 and March 2014.[123]

Of course, some people with impressive credentials, but not quite the business or FinTech savvy of Belote,[124] do not merely quibble with Belote's theoretical valuation, but instead strongly disagree.[125] They essentially base their arguments on Kickstarter's Terms of Use and executive comments, which, understandably, currently prohibit equity crowdfunding for legal, business model, and strategic industry positioning reasons.[126]

The chart above evidences each reward associated with each funding level offered during Oculus' crowdfunding campaign. Unlike Belote, we believe that a reasonable argument exists that any crowdfunder who contributed below the $300 level, which was the approximate value of the Oculus hardware at market, was satisfied with a quid-pro-quo of dollars for rewards. As a result, we believe in the reasonableness that any funder above that dollar amount would be interested in receiving a financial return in exchange for, or in addition to, the extra rewards above which could be close to quantitatively measured, such as the hardware, t-shirt, or poster. Nonetheless, we make no separate analysis for purposes of this Article and

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value. Greg Belote, *What if Oculus Crowdfunded for Equity? 145x Return.*, WEFUNDER BLOG (Mar. 26, 2014), https://wefunder.com/post/42-what-if-oculus-crowdfunded-for-equity.

[119] *Id.*

[120] *Id.*

[121] *Id.*

[122] *Id.*

[123] *Id.*

[124] *Compare* AVENUE Q, WHAT DO YOU DO WITH A B.A. IN ENGLISH? (Original Broadway Cast Recording 2003), *with* Adrianne Jeffries, *Resume*, ADRIANNE JEFFRIES BLOG, http://www.adriannejeffries.com/resume/ (last visited Aug. 8, 2014).

[125] Jeffries, *Kickstarter*, *supra* note 80.

[126] *Id.*

merely present Belote's criticisms of that analysis and agree that many shades of gray exist in conducting such a theoretical valuation.

C. *Understanding and Applying the Equity Crowdfunding Caps under Title III of the JOBS Act to Oculus Rift's Seed Funders—the Concentration of Wealth Continued*

Oculus Rift's seed investment was arguably a crowdfunding success. From a crowd of 9,522 individuals, Oculus Rift raised \$2,437,429.[127] Oculus Rift then attracted and received Series A and Series B round financing, ultimately leading to acquisition by Facebook for \$2 billion. Those who benefitted from Facebook's acquisition were Oculus Rift's original shareholders and the already wealthy and successful VCs of Spark Capital,[128] Matrix Partners,[129] Formation | 8,[130] Founders Fund,[131] and Andreessen Horowitz.[132]

It is not the purpose of this Article to vilify these organizations. In an era when the President's administration indirectly supports the dispersion of the majority of wealth allegedly held by the 1%, to the 99%, the SEC has the opportunity to allow the non-wealthy, through free market forces, to realize the returns that traditional VCs enjoy. Oculus Rift's crowd of initial funders could have expected spectacular returns per share but instead received tangible goods lacking any meaningful useful life.

As it stands, equity crowdfunding is only available to accredited investors by means of general solicitations provided by the recently amended Rule 501 of Regulation D.[133] To be an accredited investor, one

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[127] Schulte, *supra* note 80.
[128] Michael J. de la Merced, *Spark Capital Raises \$375 Million for Later-stage Investments*, N.Y. TIMES (May 28, 2014, 5:10 PM), http://dealbook.nytimes.com/2014/05/28/spark-capital-raises-375-million-for-later-stage-investments/?_php=true&_type=blogs&_r=0.
[129] *About Us*, MATRIX PARTNERS, http://www.matrixpartners.com/about-us/ (last visited Aug. 15, 2014).
[130] Yuliya Chernova, *In Facebook-Oculus Deal, Two-year-old Firm Formation 8 Scores Blockbuster Return*, WALL ST. J. (Mar. 25, 2014, 8:57 PM), http://blogs.wsj.com/venturecapital/2014/03/25/in-facebook-oculus-deal-two-year-old-firm-formation-8-scores-blockbuster-return/.
[131] Evelyn M. Rusli, *Founders Fund Hits \$1 Billion Mark for New Venture-capital Fund*, WALL ST. J. (Mar. 5, 2014, 7:59 PM), http://blogs.wsj.com/digits/2014/03/05/founders-fund-raises-1-billion-for-new-venture-capital-fund/.
[132] Scott Kupor, *Andreessen Horowitz Raises New Fund*, ANDREESSEN HOROWITZ, http://a16z.com/2014/03/27/andreessen-horowitz-raises-new-fund/ (last visited Aug. 15, 2014).
[133] Crowdfunding, Securities Act Release No. 33-9470, 78 Fed. Reg. 66,428, 66,432 (Nov. 5, 2013).

need not understand the first thing about finance or investing. As the wealthiest investor in U.S. history, Warren Buffett, once said, one need only win "the ovarian lottery,"[134] i.e., be born wealthy, to qualify as an accredited investor. Rule 501 of Regulation D lists eight ways to become accredited, and each involves either association with a wealthy organization or business entity, or having personal wealth. Limiting equity crowdfunding to these individuals and business organizations further prevents dispersion of wealth through free market forces.

By relegating equity crowdfunding only to the so-called smart money of VCs and accredited investors, and not allowing the general public the opportunity to join in the vast investment potential equity crowdfunding affords, the U.S. economy suffers as a whole.[135] Equity crowdfunding provides capital to startups and, when successful, those startups provide returns to non-wealthy investors who use that money to buy goods, services, and vacations, further bolstering the economy.[136] We believe that business crowdfunding should be more than simply a sorting mechanism[137] that makes the work of VCs easier than it already is.

Investors, however, are only half of the investment equation. Investees, such as startups like Oculus Rift, need capital. Without this type of capital, growing and developing startup businesses face a very steep uphill battle. Nevertheless, small businesses are not the only type of investees that require capital. This Article will now address the investee, or equity crowdfunding recipient's, perspective and need for capital.

IV. THE EQUITY CROWDFUNDING RECIPIENT'S PERSPECTIVE

Unlike Part II, which reviewed equity crowdfunding from the investor perspective, in terms of returns and deployment of capital gains, this Part inversely analyzes equity crowdfunding from the perspective of

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[134] Joe Weisenthal, *We Love What Warren Buffett Says About Life, Luck, and Winning the 'Ovarian Lottery,'* BUS. INSIDER (Dec. 10, 2013, 5:04 AM), http://www.businessinsider.com/warren-buffett-on-the-ovarian-lottery-2013-12.

[135] Tanya Prive, *What Is Crowdfunding and How Does It Benefit the Economy*, FORBES (Nov. 27, 2012, 10:50 AM), http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy/.

[136] *Id.*; Osmond Vitez, *The Importance of Consumer Spending*, HOUSTON CHRON., http://smallbusiness.chron.com/importance-consumer-spending-3882.html (last visited Aug. 15, 2014).

[137] *See generally* Elisabeth S. Vrba & Stephen Jay Gould, *The Hierarchical Expansion of Sorting and Selection: Sorting and Selection Cannot Be Equated*, 12 PALEOBIOLOGY 217, 218 (1986) (illustrating sorting mechanisms broadly); 827 BD. OF GOV. OF THE FED. RES. SYSTEM INT'L. FIN. DISCUSSION PAPERS, at 20 (Feb. 2005) (evidencing sorting mechanisms specifically in the economic and finance milieu).

the recipient of equity crowdfunding, rather than the funder's perspective. To underscore how equity crowdfunding matters to potential recipients of equity crowdfunding, this Part uses graduate student loans as the paradigm through which to see the pain points created in this space by the SEC's refusal to promulgate equity crowdfunding rulemaking, as required by Title III of the JOBS Act. Section A provides a brief overview of the national student debt dilemma and describes some of the criticisms that student debt entails. Section B introduces the various methods of crowdfunding and delineates such methods in the Human Capital Contract ("HCC") context. And Section C employs corporate finance principles in attempting to define HCCs as a financial instrument and to assess the financial viability of HCCs. As this Article seeks to restore public confidence in pursuing a graduate, doctoral-level education, by postulating an economically-feasible and socially-responsible, non-institutionalized model that treats higher education as an investment in human capital,[138] this Part evaluates the ex-ante and ex-post crowdfunding solutions currently available to graduate students.

A. *Student Loan Dilemma—Overview and History*

The national student debt reached all new heights in 2013, totaling well over $1 trillion.[139] Student debt shares similar characteristics with the pre-2008 housing market bubble, which has led to public outcry for student loan reform.[140] The federal government has responded to such outcry with recent proposals containing initiatives to moderate student debt adversity, which include expanding the scope of the federal income-based student loan repayment program[141] and increasing bankruptcy protection.[142]

While the federal governmental initiatives to reform student debt policy are certainly laudable, such initiatives fail to resolve the student debt

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[138] *See, e.g.*, Michael Simkovic, *Risk-based Student Loans*, 70 WASH. & LEE L. REV. 527 (2013).

[139] *See* Sam Frizell, *Student Loans Are Ruining Your Life. Now They're Ruining the Economy, Too*, TIME (Feb. 26, 2014), http://time.com/10577/student-loans-are-ruining-your-life-now-theyre-ruining-the-economy-too/ ("American students are well over $1 trillion in debt, and it's starting to hurt everyone, economists say[.]").

[140] *See, e.g.*, GLENN HARLAN REYNOLDS, THE HIGHER EDUCATION BUBBLE (Encounter Broadside Ser. No. 29, 1st Am. ed. 2012).

[141] Josh Mitchell, *2015 Budget: White House Proposes Broader Debt Forgiveness for Students*, WALL ST. J. WASH. WIRE BLOG (Mar 4, 2014, 12:29 PM), http://blogs.wsj.com/washwire/2014/03/04/2015-budget-white-house-proposes-broader-debt-forgiveness-for-students/.

[142] *See* Solvej Schou, *Finally, a Law That Would Protect People from Student Loan Hell*, YAHOO! NEWS (Feb. 12, 2014, 3:29 PM), https://news.yahoo.com/finally-law-protect-people-student-loan-hell-202905125.html.

woes of those pursuing a graduate education.[143] Graduate students incur substantially more debt than those graduating with an undergraduate degree.[144] The median debt load of a graduate student leaving school reached $57,600 in 2012.[145] Graduates with a degree in medicine or law left school owing a median debt amount of $161,772 and $140,616 in 2012, respectively.[146]

Federal student debt first became available just shortly after Russia launched Sputnik.[147] Post-World War II McCarthyism[148] spurred Congress to pass the National Defense Education Act of 1958, which first authorized federal governmental lending to students pursuing a higher education.[149] Subsequent legislation made student loans more readily available to increase student access to higher education.[150]

As student loans became more readily available, however, tuition costs rose in correlation. Former U.S. Secretary of Education William

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143 For purposes of this Article, graduate education includes academic degrees that require an undergraduate degree, such as master's degrees and professional degrees.

144 *Compare* Matthew Reed & Debbie Cochrane, *Student Debt and the Class of 2012*, THE PROJECT ON STUDENT LOAN DEBT (Dec. 2013), http://projectonstudentdebt.org/files/pub/classof2012.pdf (showing 2012 average undergraduate student debt of $29,400), *with Medical Student Education: Debt, Costs, and Loan Repayment Fact Card*, ASS'N OF AM. MED. COLLEGES (Oct. 2013), https://www.aamc.org/download/152968/data/debtfactcard.pdf (showing medical student debt averaging $170,000), *A Report of The ADEA Presidential Task Force on the Cost of Higher Education and Student Borrowing*, AM. DENTAL EDUC. ASS'N (Mar. 2013), http://www.adea.org/uploadedFiles/ADEA/Content_Conversion_Final/publications/Documents/ADEACostandBorrowingReportMarch2013.pdf (2012 dental student debt averaged a little more than $200,000), *and* Delece Smith-Barrow, *10 Law Schools Where Salaries for Grads Most Outweigh Debt*, U.S. NEWS (updated June 2, 2014, 10:30 AM), http://www.usnews.com/education/best-graduate-schools/the-short-list-grad-school/articles/2013/08/13/10-law-degrees-with-the-biggest-return-on-investment (2012 law student debt averaged $108,293).

145 *See* Josh Mitchell, *Grad Students' Loans Surge*, WALL ST. J., Mar. 25, 2014, at A2, *available at* http://online.wsj.com/news/articles/SB10001424052702303949704579459803223202602?mod=djem_jiewr_EC_domainid.

146 *Id.*

147 *See* Jennifer L. Jolly, *The National Defense Education Act, Current STEM Initiative, and the Gifted*, 32 GIFTED CHILD TODAY 50, 50 (2009).

148 *See* Nancy Murray, *Civil Liberties in Times of Crisis: Lessons from History*, 87 MASS. L. REV. 72, 80–81 (2002) (describing U.S. Anti-Communism sentiment during the 1950s).

149 *See* Note, *Ending Student Loan Exceptionalism: The Case for Risk-based Pricing and Dischargeability*, 126 HARV. L. REV. 587, 591 (2012).

150 *Id.*; *see, e.g.*, Simkovic, *supra* note 139 (providing collateral value-based rationales for the importance of higher education).

Bennett hypothesized that the increased availability of student loans allowed more students to finance their education, so schools responded by raising tuition to capture the increase in the student body.[151] The government's subsidization[152] of the education industry has prompted a revolving inflationary cycle of perpetual tuition hikes and responsive governmental injection of more loanable education funds.[153] In addition, natural market incentives preferring educated labor[154] and societal pressures[155] further contribute to the inflating cost of tuition.[156] Students continue to bear the cost of education, despite inflated prices, under the false subjective impression that the pursuit of higher education is worth incurring a substantial amount of non-dischargeable student debt. The ever-inflating national student debt connotes tell-tale signs of an expanding bubble.[157]

Student debt, whether federal or private, is not dischargeable in bankruptcy, absent a showing of undue hardship.[158] Undue hardship is not statutorily defined, which has left the meaning of undue hardship to judicial interpretation.[159] The non-dischargeable nature of student debt is one of the primary criticisms of the current state of the student loan system. Congress determined that student debt should not be dischargeable in bankruptcy

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[151] Daniel A. Austin, *The Indentured Generation: Bankruptcy and Student Loan Debt*, 53 SANTA CLARA L. REV. 329, 345 (2013) (quoting Bennett's proposal that "increases in financial aid in recent years have enabled colleges and universities to raise their tuitions, confident that Federal loan subsidies would help cushion the increase").

[152] Dept. of Treasury & Dept. of Educ., Report, *The Economics of Higher Education*, U.S. DEPT. OF TREASURY, Dec. 2012, at 2, http://www.treasury.gov/connect/blog/Documents/20121212_Economics%20of%20Higher%20Ed_vFINAL.pdf.

[153] Jonathan Noble Edel, *The Pyrrhic Victory of American Higher Education: Bubbles, Lemons, and Revolution*, 88 NOTRE DAME L. REV. 1543, 1545 & 1549 (2013).

[154] *Id.* at 1571.

[155] *Id.* at 1548; *see also* Katie McHugh, *Economist Richard Vedder: Federal Student Loans 'Fuel Academic Arms Race,'* DAILY CALLER (Jan 4. 2014, 8:16 PM), http://dailycaller.com/2014/01/04/economist-richard-vedder-federal-student-loans-fuel-academic-arms-race/#ixzz2votj3LPB (noting Ohio University economist and chair of the Center for College Affordability and Productive Richard Vedder's opinion that "'college-for-all' movement has been a very destructive movement in higher education," and that "[w]e've almost created the notion that if you haven't gone to college, you're a failure in life. You are sort of a lower form of humanity").

[156] *See* Edel, *supra* note 154, at 1558–59.

[157] *See generally* ANDREW GILLEN, A TUITION BUBBLE? LESSONS FROM THE HOUSING BUBBLE (Ctr. for Coll. Affordability and Productivity ed., 2008), *available at* http://files.eric.ed.gov/fulltext/ED536280.pdf.

[158] 11 U.S.C. § 523 (2010).

[159] *See* Michael J. Fletcher & J. Jackson Waste, *Student Loan Discharge Decisions Poke Holes in the* Brunner *Test*, AM. BANKR. INST. J., Feb. 2014.

because a student who declared bankruptcy would be "'rewarded for refusing to honor a legal obligation.'"[160] The student would, in theory, take advantage of bankruptcy, discharge all debt obligations, and consequentially reap the economic benefits typically associated with a degree, thereby receiving a cost-free education.[161] Student debt is thus classified in the same manner as: (i) a majority of tax debts, (ii) debts obtained fraudulently, (iii) debts for embezzlement, (iv) debts for child support, and (v) debts for willful and malicious injury to another.[162]

Non-dischargeable six-figure student debt not only burdens the graduate, but also hinders the U.S. economy as a whole. Graduates saddled with substantial student debt must necessarily opt out of making big-ticket purchases and investments to satisfy their monthly student debt obligations. Defaulting on student loans comes with harsh repercussions (e.g. wage garnishment, tax offset, or legal action). Indebted graduates are postponing their decisions to invest in real estate,[163] start families, purchase cars or other consumer goods, start new businesses, and invest in the U.S. capital markets.[164] The U.S. economy thrives on consumerism and investment.[165] A burgeoning demographic of graduates clad with seemingly insurmountable student debt constrains the flow of capital, which is deleterious to U.S. economic growth and long-term sustainability.

B. *Crowdfunding and Human Capital Contract*

The advent of crowdfunding as a workable mechanism for raising capital has enabled individuals to finance a sweeping array of endeavors,

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[160] Brendan Baker, *Deeper Debt, Denial of Discharge: The Harsh Treatment of Student Loan Debt in Bankruptcy, Recent Developments, and Proposed Reforms*, 14 U. PA. J. BUS. L. 1213, 1217 (2012) (quoting Representative Allen E. Ertel).

[161] *See generally* H.R. REP. NO. 95-595, at 536–37 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6424.

[162] Roger Roots, *The Student Loan Debt Crisis: A Lesson in Unintended Consequences*, 29 SW. U. L. REV. 501, 513 (2000).

[163] *See* Dina ElBoghdady, *Student Debt May Hurt Housing Recovery by Hampering First-time Buyers*, WASH. POST (Feb. 17, 2014), http://www.washingtonpost.com/business/economy/student-debt-may-hurt-housing-recovery-by-hampering-first-time-buyers/2014/02/17/d90c7c1e-94bf-11e3-83b9-1f024193bb84_story.html (stating that new federal rules restrict prospective first-time home buyers from obtaining mortgages).

[164] Kathleen Negri, *Mortgaging the American Dream: The Misplaced Role of Accreditation in the Federal Student Loan System*, 82 FORDHAM L. REV. 1905, 1915 (2014).

[165] Amitai Etzioni, *The Crisis of American Consumerism*, HUFFINGTON POST (Sept. 4, 2012, 3:57 PM), http://www.huffingtonpost.com/amitai-etzioni/the-crisis-of-american-co_b_1855390.html.

from creative projects[166] to social causes.[167] Individuals also utilize crowdfunding to support their own individual objectives,[168] most notably the pursuit of graduate education. This concept of investing in another's pursuit of higher education, known as the Human Capital Contract, is not a new revelation.[169] Nobel Laureate economist Milton Friedman conceptually introduced the HCC[170] well before his famed *New York Times* article, "The Social Responsibility of Business Is to Increase its Profits,"[171] disseminated the shareholder primacy theory[172] through the economic mainstream and influenced today's business education.[173] The HCC theory has resurged as a topic of recent scholastic interest, in an effort to curb the mounting national student debt dilemma.[174]

The fight to pacify further student debt augmentation has extended beyond the federal level, as some states recently have introduced tuition plans that capture the essence of HCC theory.[175] However, whether these

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[166] *See, e.g.*, *The Year in Kickstarter,* KICKSTARTER, https://www.kickstarter.com/year/2013/ (last visited Nov. 8, 2014).

[167] *See* Carlos Pierre, *Bridging the Missing Middle: The Impact of Larger Loans on Kiva*, KIVA BLOG (Dec. 27, 2013), http://blog.kiva.org/2013/12/27/bridging-the-missing-middle-the-impact-of-larger-loans-on-kiva.

[168] *See, e.g.*, Verstein, *supra* note 25, at 447.

[169] *See, e.g.*, Miguel Palacios, *Human Capital Contracts: "Equity-like" Instruments for Financing Higher Education*, POL'Y ANALYSIS NO. 462, Dec. 16, 2002, *available at* http://object.cato.org/sites/cato.org/files/pubs/pdf/pa462.pdf; Anand Reddi et al., *Human Capital Contracts for Global Health: A Plan to Increase the Number of Physicians in Resource Limited Settings*, 26 AIDS (London) 1979 (2012); David Bornstein, *A Way to Pay for College, with Dividends*, N.Y. TIMES (June 2, 2011, 9:43 PM), http://opinionator.blogs.nytimes.com/2011/06/02/a-way-to-pay-for-college-with-dividends/?_php=true&_type=blogs&_r=0; Anand Reddi & Andreas Thyssen, *Healthcare Reform: Solving the Medical Student Debt Crisis Through Human Capital Contracts*, HUFFINGTON POST (June 10, 2011, 4:12 PM), http://www.huffingtonpost.com/anand-reddi/healthcare-reform-solving_b_874651.html.

[170] *See* MILTON FRIEDMAN, CAPITALISM AND FREEDOM (Univ. Chi. Press 40th anniversary ed. 2002).

[171] *See* Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970, at SM17.

[172] *See, e.g.*, Lynn A. Stout, *Bad and Not-so-bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1190–91 (2002).

[173] *See generally* Craig N. Smith & David Ronnegard, *Shareholder Primacy, Corporate Social Responsibility, and the Role of Business Schools* (INSEAD, Working Paper No. 2014/13/ATL/ISIC, 2014), *available at* http://ssrn.com/abstract=2322780.

[174] *See* Palacios, *supra* note 170.

[175] *See* ECON. OPPORTUNITY INST., PAY IT FORWARD: AN UPDATE ON NATIONAL PROGRESS (Apr. 3, 2014), *available at* http://www.eoionline.org/education/higher-education/an-update-on-national-progress/; *One Year After Oregon Passage, Tuition-free College Model "Pay It Forward" Being Considered in 25 States*,

tuition plans apply to prospective graduate students is a question yet to be answered. Recently, Senator Marco Rubio (R-Florida) and Representative Tom Petri (R-Wisconsin) introduced new legislation, the Investing in Student Success Act, which sets basic standards for HCCs, or "income-share agreements."[176] Oren Bass, Pave CEO and co-founder, stated:

> "If this legislation passes, it would bring this kind of funding to the forefront as a mainstream option, enabling millions of American students to access affordable capital, which would in turn help to overcome underemployment, provide financial flexibility, and allow a greater ability to take calculated risks instead of accepting jobs specifically to service debt payments."[177]

Additionally, for "the first time investors can invest in people within fields they care about, bolstering chances for success within industries or across communities."[178]

HCC funding platforms are gaining much traction and media attention as a possible alternative means of providing graduate education financing. HCC funding platforms allow graduates to resolve student debt burdens either ex-ante or ex-post. HCC funding platforms help mitigate student debt burdens ex-ante by allowing students accepted at an institution of higher education to obtain HCC funding to finance the cost of education. HCC funding platforms also help students ex-post by offering student debt refinancing to students already suffering from student debt woes. Graduates, therefore, can finance their educations before or after incurring the costs of pursuing a graduate education.

C. *Unpacking Human Capital Crowdfunding's Capital Structure*

This section conceptualizes graduate decision-making in financing higher education by employing corporate capital structure theories and concepts to assess the economic viability of HCCs.

HCCs feature a combination of debt- and equity-like

ECON. OPPORTUNITY INST. (July 1, 2014), http://www.eoionline.org/blog/one-year-after-oregon-passage-tuition-free-college-model-pay-it-forward-being-considered-in-25-states/.

[176] *See* Miguel Palacios & Andrew P. Kelly, *A Better Way to Finance That College Degree,* WALL ST. J. (Apr. 13, 2014, 6:38 PM), http://online.wsj.com/news/articles/SB10001424052702303456104579485801253355622.

[177] Charles Luzar, *Bill Introduced to Cement Crowdfunding Individuals & Higher Ed via Income Share Agreements*, CROWDFUND INSIDER (Apr. 10, 2014, 10:42 AM), http://www.crowdfundinsider.com/2014/04/35695-bill-introduced-cement-crowdfunding-individuals-higher-ed-via-income-share-agreements/.

[178] *Id.*

characteristics, blurring the line between a security, subject to federal securities regulation, and a consumer loan. The fixed percentage of a graduate's income paid to the human capital investor parallels dividends paid to shareholders from a corporation's income, which is a vital aspect of equity.[179] At the same time, the human capital investor's legal right to fixed payments of a graduate's future earnings is contractual, which is a key function of debt.[180] The HCCs' hybridization of qualities attributable to debt and equity mirror the structure of corporate preferred stock,[181] as both feature equity- and debt-like characteristics.[182] The contractual component of HCCs could potentially afford a flexible method for aligning graduate and human capital investor interests.[183]

Graduate education financing decision-making can be better understood in terms of the pecking order theory.[184] Under the pecking order theory, graduates prefer to finance their educations first from internal capital sources, such as personal or family funds.[185] If graduates are unable to finance the cost of education with internal capital, then they next resort to external sources of debt capital[186] (i.e. student loans) since debt capital is cheaper and more readily accessible.[187] In addition, graduates retain relative decision-making autonomy and are not otherwise constrained by investor monitoring or control.[188] However, once graduates reach a certain level of debt, they are more inclined to seek external equity capital from human capital investors,[189] in which graduates are more willing to sacrifice a portion of future earnings to finance education-related costs.

The pecking order theory leads to the assumption that graduates seeking equity capital will have at least some existing student debt obligations. The total mix of graduate debt and equity constitute a graduate's capital structure.[190] A graduate's optimal capital structure is the combination of graduate debt and equity that "minimizes the [graduate's] weighted cost" of financing education.[191] The total cost ultimately borne by a graduate in paying both student loan creditors and human capital investors

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[179] *See generally* Melissa M. McEllin, Note, *Rethinking* Jedwab*: A Revised Approach to Preferred Shareholder Rights*, 2010 COLUM. BUS. L. REV. 895 (2010).
[180] *See generally id.*
[181] *See generally id.*
[182] *See generally id.*
[183] *See generally id.*
[184] *See* Stewart C. Myers, *Capital Structure*, 15 J. ECON. PERSPECTIVES 81 (2001).
[185] *See id.* at 92.
[186] *See id.*
[187] *Id.* at 92–93.
[188] *See id.* at 93 & 96.
[189] *See id.* at 93.
[190] *See* R. CHARLES MOYER ET AL., CONTEMPORARY FINANCIAL MANAGEMENT 470 (12th ed. 2011).
[191] *Id.* at 471.

comprises the graduate's cost of capital,[192] which is quantifiable using the Weighted Average Cost of Capital (WACC) formula,[193] here referred to as Weighted Average Cost of Human Capital (WACHC).

The venture capital approach traditionally employed to value a startup provides a feasible starting point for human capital valuation.[194] Young graduates are not wrought with the same type of valuation issues and uncertainties as young companies.[195] Thus, investors may be able to utilize various valuation methodologies to better forecast more accurate and precise rates of return for their investments in human capital.

V. APPLYING FEDERAL SECURITIES REGULATION TO EQUITY CROWDFUNDING GENERALLY AND HCCS SPECIFICALLY

This Part first analyzes HCCs within the authority of the current federal securities regulatory regime. This Part then identifies potential issues involved with HCCs with and without federal securities regulation. Lastly, this Part proposes a federal securities exemption for the individuals obtaining graduate education financing via crowdfunding while still applying federal securities laws to HCC platforms.

A. *Background*

The 33 Act delineates a lengthy catalogue of financial instruments that, "unless the context otherwise requires," fall under the Act's definition of a "security."[196] These include stocks, bonds, certificates of interest, or participation in any profit-sharing agreement, notes and investment contracts.[197] The breadth of the securities laws is one of the primary contributing factors to Upstart's decision to withdraw from offering HCCs on its platform.[198] This section evaluates HCC transactions under the following three definitions: (1) a "certificate of interest or participation in any profit-sharing agreement;" (2) an "investment contract;" and, alternatively, (3) a "note" constituting a security.

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[192] *See id.*

[193] *See* Murray Z. Frank & Tao Shen, Investment and the Weighted Average Cost of Capital (Sept. 4, 2014) (unpublished manuscript) (providing a WACC formula of (E/V)re + (1 – tc)(D/V)rd)), *available at* http://ssrn.com/abstract=2014367.

[194] *See, e.g.*, Aswath Damodaran, Valuing Young, Start-up and Growth Companies: Estimation Issues and Valuation Challenges (May 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418687.

[195] *See, e.g.*, *id.*

[196] 15 U.S.C. § 77b(a)(1) (2012).

[197] *Id.*

[198] Alison Griswold, *Upstart Pulls Income Share Agreements in Favor of More Traditional Loans*, MONEYBOX (May 9, 2014, 3:06 PM), http://www.slate.com/blogs/moneybox/2014/05/09/upstart_pulls_income_share_agreements_in_favor_of_traditional_loans.html.

The Investing in Student Success Act will provide the legal framework for income-sharing agreements (i.e. HCCs). "Income-sharing agreement" appears to fall under the definition of a "security," at least nominally, as a "certificate of interest or participation in any profit-sharing agreement." An individual's net income is virtually synonymous with a company's net profits. However, the mere fact that an agreement is labeled as an instrument within the definition of a "security" does not necessarily render such instrument a "security."[199] Further analysis of HCCs under the judicially constructed definitions of an "investment contract" and a "note" is, therefore, required.

B. *Human Capital "Investment Contract"*

Neither the 33 Act nor 34 Act provides a definition of an investment contract.[200] As a result, the Supreme Court in *Howey* defined investment contract as any transaction or scheme in which a person invests money in a common enterprise with expectations of profits derived solely from the efforts of others.[201] The Court's definition of an investment contract sets forth the analytical framework for determining whether a particular transaction or scheme constitutes an investment contract, which is divisible into the following four elements: (1) investment of money; (2) common enterprise; (3) expectations of profits; and (4) derived solely from the efforts of others.[202] A brief analysis of each element of the *Howey* test supports the contention that HCCs constitute an investment contract.

1. *Investment of Money*

An investment occurs where the investor "parts with his money in the hope of receiving profits from the efforts of others, not where [the investor] purchases a commodity for personal consumption."[203] Human capital investors cannot personally consume or use a graduate degree

[199] *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 848 (1975) ("We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called 'stock,' must be considered a security transaction simply because the statutory definition of a security includes the words 'any . . . stock.'" (footnote omitted)).
[200] *See* SEC v. W. J. Howey Co., 328 U.S. 293, 297–98 (1946).
[201] *Id.* at 298–99.
[202] *Id.*
[203] *See Forman*, 421 U.S. at 858 (providing that the securities laws do not apply when a purchaser is motivated by a desire to use or consume the item purchased); *see also* Warfield v. Alaniz, 569 F.3d 1015 (9th Cir. 2009) (holding that annuities promising a lifetime stream of income and directing any remaining funds at death to a designated charity satisfied the first prong of the *Howey* test where promotional materials primarily marketed the annuities as investments).

designated to another.[204] Rather, human capital investors are driven by capitalistic, albeit socially conscious, motives in choosing to finance a postgraduate's education. Viewed objectively, human capital investors expect a return on their capital contributions. Since cash, or its equivalent,[205] can be valued in monetary terms[206] and human capital investors contribute cash to cover a graduate's education in exchange for a percentage share in the graduate's future income, such cash contributions equate to an investment of money.

2. *Common Enterprise*

Courts are incongruous in defining "common enterprise."[207] Courts are split between two distinct approaches in determining whether a common enterprise exists: (a) the horizontal commonality approach or (b) the vertical commonality approach.[208] The horizontal commonality approach requires a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis among investors.[209] If multiple human capital investors contribute capital to finance a graduate's education, the human capital investors' collective contributions demonstrate a common enterprise under the horizontal approach.

The vertical commonality approach is divisible into two additional sub-approaches: (i) broad and (ii) strict. The "broad vertical commonality" approach merely requires investor dependence on the "'expertise or efforts of the investment promoter for their returns.'"[210] The definition of "promoter" has an expansive reach and includes[211]

> (i) Any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer; or

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[204] *See* Stevens v. Stevens, 492 N.E.2d 131, 133 (Ohio 1986)(quoting *In re* Marriage of Graham, 194 Colo. 429, 432 (1978)("'[A professional degree] does not have an exchange value or any objective transferable value on an open market.'").
[205] *See generally* J. MARTIN BURKE & MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL INCOME (10th ed. 2012).
[206] *See* 2 MERTENS LAW OF FEDERAL INCOME TAXATION: TREATIES AND RULINGS § 12A:34 (West 2014).
[207] *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 44–46 (7th ed. 2013).
[208] *Id.*
[209] SEC v. Infinity Group Co., 212 F.3d 180, 188 (3d Cir. 2000).
[210] *See* SEC v. ETS Payphones, Inc., 408 F.3d 727, 732 (11th Cir. 2005)(quoting SEC v. ETS Payphones, Inc., 300 F.3d 1281, 1284 (11th Cir. 2002)).
[211] *See* Keith Paul Bishop, *Just Who Is A Promoter And Why You May Want To Know*, ALLEN MATKINS CAL. CORP. & SEC. L. (Nov. 11, 2013), http://calcorporatelaw.com/2013/11/just-who-is-a-promoter-and-why-you-may-want-to-know/.

> (ii) Any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10 percent or more of any class of securities of the issuer or 10 percent or more of the proceeds from the sale of any class of such securities. However, a person who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this paragraph if such person does not otherwise take part in founding and organizing the enterprise.[212]

Graduates and funding platforms alike appear to fit within the statutory mold of a "promoter," at least until the SEC's Proposed Crowdfunding rules become a reality.[213] Assuming *arguendo* that graduates and funding platforms are "promoters," human capital investors are dependent upon the "expertise and efforts"[214] of both. First, human capital investor returns are *dependent* on a graduate's ability to earn income in the future. Anything that may cause a graduate to earn less income, or no income at all, affects human capital investor returns. In addition, for all intents and purposes, human capital investors *require* a HCC funding platform's technological infrastructure to calculate, process and receive payments.[215] HCC funding platforms also provide all the channels of communication between graduates and human capital investors.[216] Thus, a common enterprise exists under the broad vertical commonality approach as a result of the human capital investors' nearly absolute dependence on graduates and HCC funding platforms.

Even the "strict" vertical commonality approach suggests a common enterprise. The strict vertical commonality approach requires a direct correlative link between investor returns and promoter profits.[217] As already noted, investor returns directly correlate with graduate future earnings.[218] With respect to the funding platform, the HCC funding platform's profits depend on graduate future earnings and human capital

[212] *Id.* (quoting 17 C.F.R. § 230.405 (2008)).
[213] *Id.* (quoting 17 C.F.R. § 230.405 (2008)). The Proposed Rules do not appear to redefine "promoter."
[214] *See ETS Payphones,* 408 F.3d at 732.
[215] *See A Smarter Loan*, UPSTART, https://www.upstart.com/borrow (last visited Mar. 19, 2014) (describing process for predicting future earnings).
[216] *See id.*
[217] *See* Susan S. McDonald, *Toward Consistent Investor Protection Under the Federal Securities Laws: The Solution to the Conflict Among the Circuits Regarding the So-Called "Commonality" Requirement for an "Investment Contract,"* 32 SEC. REG. L.J. 68, 68 (2004).
[218] *See* Jeffries, *Kickstarterr, supra* note 80.

investor contributions. The HCC funding platform's profits vary to the same extent as human capital investors with respect to graduate future repayments. For instance, assume hypothetically that the HCC funding platform charges a 2.5% transaction fee for every payment received from the graduate. If the graduate pays $400 per month from earnings to one investor, then the HCC funding platform would profit $10 per monthly transaction, leaving the human capital investor with $390 in profit.[219] If the graduate's income subsequently increases such that the graduate's payments increase to $500 per month, the HCC funding platform would then profit $12.50 per monthly transaction, which leaves the HCC investor with $487.50 in profit. For both the human capital investor and HCC funding platform, profits grew 25%, which demonstrates the correlation between human capital investor and HCC funding platform-promoter return. Thus, the strict vertical commonality approach also indicates the existence of a common enterprise.

3. *Expectation of Profits*

"Expectation of profits" represents the income or return, whether fixed or variable,[220] that investors seek on their investments from dividends, periodic payments, or increased value of the investment.[221] The express contractual covenants in which a graduate promises to pay the human capital investor a fixed or variable percentage of the graduate's future earnings, for a specified period of time, documents the human capital investor's legal right to receive payment. A covenant expressly imposing a legally enforceable contractual obligation on the graduate solidifies the human capital investor's expectation of profits.

4. *Profits Derived from the Effort of Others*

Although the fourth element under *Howey* provides that profits must be derived *solely* from the efforts of the promoter or a third party,[222] post-*Howey* Circuit Courts have opted for a slightly more relaxed interpretation of *Howey*'s fourth element, in which profits must be derived *substantially* from others.[223] An investor may, therefore, retain a modicum

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219 $400 x 0.025 = $10

220 *See* SEC v. Edwards, 540 U.S. 389, 394 (2004) ("There is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the [*Howey*] test.").

221 *Id.*; *see also* In the Matter of Abbett, Sommer & Co., Exchange Act Release No. 34-8741, 44 SEC Docket 104 (1969) (holding investment contracts include mortgage notes containing a management services package and a promise to repurchase the notes in the event of default).

222 SEC v. W. J. Howey Co., 328 U.S. 293, 297 (1946).

223 *See, e.g.*, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973).

of control over an investment or put forth the effort necessary to ensure success of an investment, provided that the profits derive *substantially* from the efforts of others.[224]

Graduates perform the actual income-producing activities, which benefit the human capital investors. Even if a human capital investor tries to influence[225] a graduate's decision-making (*e.g.*, mentor-like career advice), or to help a graduate maximize earnings (*e.g.*, assisting with job placement), a human capital investors' efforts are incomparable to a graduate's active efforts in earning an income. Additionally, assuming again that HCC platforms are "promoters" under Rule 405 of the 33 Act, human capital investors rely on the HCC platform's efforts in securing and remitting payment, as well as continued maintenance and provision of web application services. In sum, HCCs thus appear to fall within *Howey*'s "investment contract" analysis, subjecting HCCs to federal securities regulation.

C. *Notes—The Family Resemblance Test*

Because HCCs create a debt-like, enforceable legal right to a percentage share of graduate future earnings, HCCs also resemble notes. Under the federal securities laws, a "note"[226] is presumed to be a "security," which is only rebuttable by showing that the note bears a strong resemblance to one of the enumerated categories of notes that escape the crosshairs of the 33 Act's definitional scope of a "security."[227] Notes categorically excluded from the federal securities laws consist of: (i) notes delivered in consumer financing, (ii) notes secured by home mortgages, (iii) short-term notes to a small business secured by the business's assets, (iv) short-term notes secured by assignment of accounts receivable, (v) notes formalizing an open-account debt incurred in the ordinary course of business; (vi) notes evidencing a character loan to a bank customer; or (vii) notes evidencing loans by commercial banks for current operations.[228] On the surface, HCCs do not appear to fall within one of the categories of excluded notes due to HCCs' unique combination of debt- and equity-like characteristics.

The Court in *Reves* articulated the "family resemblance test," a four-factor analytical framework to determine whether a particular "note"

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[224] *See, e.g.*, *Koscot*; *Turner Enterprises*.

[225] RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f(1) (2006) (suggesting that influence does not necessarily rise up to the level of control).

[226] Reves v. Ernst & Young, 494 U.S. 56, 62 (1990) (construing a note as a "relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context . . . .").

[227] *Id.* at 63–64.

[228] *Id.* at 65.

bears a strong resemblance to one of the aforementioned enumerated categories of notes.[229] If the note is not sufficiently similar to one of the enumerated categories, a determination whether to create a new category requires assessment of the same four factors.[230] The "family resemblance test" examines the: (1) parties' transactional motivations; (2) distribution plan; (3) consuming public's reasonable expectations; and (4) factors significantly reducing the instrument's risk.[231]

1. *Transactional Motivations*

The first factor requires ascertaining the motivations prompting a reasonable issuer and investor to enter into the transaction.[232] A note is more likely to be a security if the issuer's purpose is to obtain capital to finance a substantial investment and the investor's purpose lies primarily in the expected profit from the note.[233] On the other hand, a note is less likely to be a security if the transaction's purpose is consumer-driven or commercial.[234]

Graduates seek funding for their education, often cited as an "investment,"[235] and human capital investors do expect some kind of a financial return from the graduate's future earnings.[236] However, a human capital investor's primary motive may not actually be profit-driven. The common public recognition that graduates are burdened with substantial student debt suggests that human capital investors are not primarily motivated by profits, but rather by social responsibility, to provide relief to graduate students whose insurmountable debt obligations constrain their aspirations. HCCs, thus, involve motivations that are uncharacteristic of a typical profit-driven investment.

Moreover, HCCs connote a consumer-focused transaction similar to traditional student loans. Student loans become due on a certain date

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[229] *Id.* at 66.
[230] *Id.* at 67.
[231] *Id.* at 66–67.
[232] *Id.* at 66.
[233] *Id.*; *see also, e.g.*, United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975) (share of "stock" carrying a right to subsidized housing not a security because "the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit").
[234] *Reves* at 66.
[235] *See, e.g.*, Paul Taubman & Terence Wales, *Education as An Investment and A Screening Device*, *in* EDUCATION, INCOME, AND HUMAN BEHAVIOR 95 (F. Thomas Juster ed., 1975); Michael Simkovic, *Risk-Based Student Loans*, 70 WASH. & LEE L. REV. 527, 533–47 (2013) (describing higher education as an investment in human capital).
[236] *See* Intelligent Digital Sys., LLC v. Visual Mgmt. Sys., Inc., 683 F. Supp. 2d 278, 284 (E.D.N.Y. 2010).

after graduation and demand fixed monthly payments for a specified term. To satisfy the student loan payment obligations enforceable at law, graduates must necessarily allocate a percentage share of their monthly incomes to pay down their student debt. Like student loans, HCCs also create a legal obligation to repay, in fixed payments, for a specified period of time that commences after that student's graduation or attrition from a given graduate program. HCCs involve transactions that certainly resemble traditional student loans. The socially-driven, consumer-focused nature of HCCs might provide at least some evidence that HCCs do not fall within the definition of a note that would constitute a security.

2. *Distribution Plan*

The second factor requires examining the instrument's distribution plan.[237] An instrument is more likely to fall within the definition of a "security" if its distribution plan involves "common trading for speculation or investment."[238] Such "common trading" occurs when notes are offered to the public at large to permit secondary sales.[239] HCCs comprise a single quid pro quo transaction between graduates and human capital investors. No trading persists upon execution of that transaction, which supports an interpretation that HCCs are not the types of investment in *common* trading. Although no common trading exists, HCCs are still initially offered to the public, much like a traditional corporate IPO.[240] Thus, the distribution plan for HCCs weighs in favor of defining HCCs as a "note" constituting a security.

3. *Public Expectation*

The third factor considers "the reasonable expectations of the investing public."[241] An instrument is more akin to a "security" if the instrument is marketed as an investment.[242] HCC funding platforms expressly promise investor returns on their websites, which prompts the investing public to believe that HCCs are, in fact, investments.[243] The HCC funding platforms' marketing schemes tend to favor classifying HCCs as securities.

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[237] *See Reves* at 66.
[238] *Id.*
[239] Verstein, *supra* note 25, at 485–86.
[240] *See Reves*, 494 U.S. at 68 (indicating that defendant "offered and sold to a broad segment of the public, and that is all we have held to be necessary to establish the requisite 'common trading' in an instrument" (citation omitted)).
[241] *Id.* at 66.
[242] *Id.* at 69.
[243] *See, e.g.*, SOFI, https://www.sofi.com (last visited May 19, 2014).

4. *Risk-Reducing Factors*

The final factor assesses those factors that significantly reduce the risk of the instrument rendering the 33 Act unnecessary.[244] The existence of an alternative regulatory scheme is one such risk-reducing factor.[245] Graduate indebtedness is overseen by the U.S. Departments of Treasury and Education, as well as the Consumer Financial Protection Bureau.[246] Three U.S. governmental bodies regulate graduate indebtedness, such that federal securities regulation of HCCs may be wholly superfluous. In addition, the face-to-face, *human* social interactions between graduates and human capital investors reduce the risk of fraud that the federal securities laws seek to deter.[247] The effectiveness of these available alternative regulatory schemes remains to be seen.

D. *Potential Problems*

1. *Natural Person as an Issuer*

Section 4A(f) of the SEC's Proposed Crowdfunding rules exclude "[i]ssuers that are not organized under the laws of a state or territory of the United States or the District of Columbia . . . ."[248] Debt burdened or soon-to-be debt burdened graduates are certainly not "organized," but acquire rights upon birth.

2. *Taxation and Non-Dischargeability*

HCCs could pose additional tax burdens on graduates already burdened with student debt. HCCs involve graduate assignment of future earnings in exchange for cash contributions to finance further education. HCC tax issues include: (1) a graduate's current tax liability upon receipt of HCC funds and (2) a graduate's future tax liability upon future receipt of income.

First, the funds a graduate receives from a human capital investor

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[244] *Reves*, 494 U.S. at 67.
[245] *Id.*
[246] *See* Annamaria Andriotis & Alan Zibel, *Student-loan Refinancing Makes Reappearance*, WALL ST. J. (Feb. 24, 2014, 7:51 PM), http://online.wsj.com/news/articles/SB1000142405270230483470457940358067218 3044.
[247] Basic Inc. v. Levinson, 485 U.S. 224, 243–44 (1988) ("The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases. . . .").
[248] Crowdfunding, Securities Act Release No. 33-9470, 78 Fed. Reg. 66,428, 66,436 (proposed Oct. 13, 2013).

are likely to be taxable upon receipt,[249] whereas funds from student debt are not considered "income" at the time of receipt.[250] In addition, HCC funds may be taxable even if graduates assign the full amount to an educational institute.[251]

Second, future earnings are later taxable once earned by the graduate, similarly to the double taxation imposed on corporations.[252] The graduate's income is first taxed. Subsequently, the portion of the graduate's income is taxed *again* once the human capital investor receives it, ultimately reducing the human capital investor's return in the future.[253]

Additionally, any HCC funds for graduate education received are likely to be non-dischargeable. HCCs impose upon graduates a legal "obligation to repay funds received as an educational benefit, scholarship, or stipend," which is exempted from bankruptcy discharge.[254]

3. *Fiduciary Duties*

HCCs pose potential problems regarding the fiduciary duties owed between investors, graduates and funding platforms, begging the question to whom each of the parties owe fiduciary duties.

The law of agency[255] imposes certain fiduciary duties[256] upon principals and agents. With respect to corporations, agency only exists in theory.[257] The positivist agency theory[258] focuses primarily on the agency

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[249] *See* 26 U.S.C. § 61 (2012) ("[G]ross income means all income from whatever source derived…").

[250] Comm'r of Internal Revenue v. Tufts, 461 U.S. 300, 307 (1983).

[251] *See, e.g.*, Helvering v. Horst, 311 U.S. 112, 117 (1940) (citing Burnet v. Wells, 289 U.S. 670 (1933))("The taxpayer has equally enjoyed the fruits of his labor or investment and obtained satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them."); *see also* Comm'r of Internal Revenue v. Giannini, 129 F.2d 638, 640–41 (9th Cir. 1942).

[252] James S. Eustice & Thomas Brantley, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS ¶ 1.03 (2014), *available at* 1999 WL 516443.

[253] *See* 26 U.S.C. § 61 (2014).

[254] 11 U.S.C § 523(a)(8)(A)(ii) (2010).

[255] RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) (defining "agency" as the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") who shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act).

[256] *Id.* at cmt. e ("As a general matter, the term 'fiduciary' signifies that an agent must act loyally in the principal's interest as well as on the principal's behalf.").

[257] *See generally, e.g.*, Kathleen Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57–74 (1989) (analyzing the agency theory in detail).

relationship between corporate shareholders (principals) and management (agents).[259] As applied to HCCs. the positivist agency theory would treat graduates as agents and investors as principals. However, such treatment is wrought with inconsistencies. First, graduates are not acting on behalf of investors in pursuing further education or a particular career path.[260] Second, investors may exercise influence[261] over a graduate, but otherwise lack the sort of control that principals typically wield. Lastly, agency law does not resolve whether funding platforms qualify as agents or principals. Fiduciary duties must be established transparently.

4. *Soft Misinformation Fraud Liability*

Rule 10b-5 provides fraud liability for misstatements or omissions of material fact.[262] The materiality of a misstated (or omitted) fact is a key component of fraud liability under Rule 10b-5.[263] Soft misinformation involves misstating or failing to state "events or activities that will occur, if at all, at some future date."[264] In the HCC arena, the materiality of soft misinformation becomes a crucial concern since a graduate's "puffery," or "sales pitch," could subject that student to 10b-5 fraud liability.

5. *Control and the Thirteenth Amendment*

In the corporate context, a corporate equity holder is commonly equated to "owning" a share of the corporation.[265] Equity holders receive

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[258] *Id.* at 59 (acknowledging that the positivist agency theory attracted "considerable research" and "popular interest" but also recognizing that the positivist agency was criticized as "minimalist," "tautological" and "lacking").
[259] Lex Donaldson & James H. Davis, *Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*, 16 AUSTL. J. MGMT. 49–64 (1991).
[260] RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. g (2006) ("It is possible to create a power to affect a person's legal relations to be exercised for the benefit of the holder of the power. Such powers typically are created as security for the interests of the holder or otherwise to benefit a person other than the person who creates the power. Consequently, the holder of such a power is not an agent as defined in this section, even though the power has the form of agency and, if exercised, will result in some of agency's legal consequences").
[261] *Id.* at cmt. f(1)("Family ties, friendship, perceived expertise, and religious beliefs are often the source of influence or dominance, as are the variety of circumstances that create a strong position in bargaining. A position of dominance or influence does not in itself mean that a person is a principal in a relationship of agency with the person over whom dominance or influence may be exercised.")
[262] 17 C.F.R. § 240.10b-5 (2014).
[263] *See id.*
[264] *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 643 (7th ed. 2013).
[265] *E.g.*, D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES (3d ed. 2012).

various control rights reminiscent of rights afforded to common law property owners. Along these lines, transcribing ownership from a corporate perspective to actual human beings prompts potential controversy. The notion of "ownership" in an individual recapitulates an antiquated system of racial subjugation and forced labor embedded in American history. From this angle, HCCs could be misconstrued as a clandestine medium of involuntary servitude violative of the Thirteenth Amendment.

However, involuntary servitude is limited to the types of mandatory labor "akin to African slavery, which, in practical operation, would tend to produce like undesirable results."[266] An individual is subject to involuntary servitude if coerced to work by use or threat of physical force or legal sanctions.[267] Involuntary servitude virtually strips an individual's freedom of choice.[268]

Throughout the term of the HCC, from creation to expiration, a graduate is never left without a choice. A postgrad maintains the ability to choose whether or not to: (1) enter into the HCC from the outset; (2) remain enrolled in a graduate program; (3) forego the highest paying job opportunity; and (4) stay with a particular employer. With such freedom to choose, the requisite labor cannot be said to be involuntary. Graduates financing their education solely with student debt must also work to satisfy their financial obligations to lenders.

VI. CONCLUSION AND PROPOSAL

Broadly, this Article extended our prior case-study based research regarding entrepreneurship.[269] Specifically, however, this Article evidenced the harm to average businesses, entrepreneurs, technology firms, investors, students, other meaningful economic actors and the U.S. economy as a whole because of the SEC's refusal to promulgate final rules and regulations required of the Commission by law. Legislators must consider the aforementioned issues when drafting legislation concerning HCCs. Any legislation should mandate an exemption of transactions involving HCCs

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[266] Butler v. Perry, 240 U.S. 328, 332 (1916).

[267] United States v. Kozminski, 487 U.S. 931, 944 (1988).

[268] *See, e.g.*, Flood v. Kuhn, 443 F.2d 264 (2d Cir. 1971), *cert. granted*, 404 U.S. 880 (1971), *aff'd*, 407 U.S. 258 (finding no violation because player free to stop playing baseball); Cummings v. Va. Sch. of Cosmetology, Inc., 466 F. Supp. 780 (E.D. Va. 1979) (finding no violation because students voluntarily entered into contract and were free to leave school).

[269] *See, e.g.*, David Groshoff, *Contrepreneurship?: Examining Social Enterprise Legislation's Feel-Good Governance Giveaways*, 16 U. PA. J. BUS. L. 233, 283 n.306 (2013); David Groshoff, *Unchartered Territory: Market Competition's Constitutional Collision With Entrepreneurial Sex-Segregated Charter Schools*, 2010 BYU EDUC. & L.J. 307, 307 (2010).

from the registration and disclosure requirements under the securities laws. Moreover, legislators should also impose certain oversight duties upon HCC funding portals, since funding portals stand in the best position to detect and prevent fraud. We believe that crowdfunding can serve as more than a sorting device or a mechanism through which compliance costs become, per usual, extracted away by rent-seeking behaviors of accounting firms. Instead, we believe in the power of crowdfunding to allow for job creation, economic expansion, technological advancement, and, at a personal level, to allow all people—not just accredited investors—to combine finance and technology to pursue their dreams.